Internal Revenue Bulletin

Cumulative Bulletin 1962–3

Federal Tax Laws and Committee Reports

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In this issue

FINDING LIST

ABBREVIATIONS

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A, B, C, etc.—The names of individuals.
A.R.R.—Committee on Appeals and Review recommendation.
A.T.—Alcohol and tobacco tax ruling.
B.T.A.—Board of Tax Appeals.
C.B.—Cumulative Bulletin.
C.F.R.—Code of Federal Regulations.
Ct. D.—Court Decision.
Del. Order—Delegation Order.
D.C.—Treasury Department circular.
E.O.—Executive Order.
E.T.—Estate and gift tax ruling.
Em. T.—Employment tax ruling.
F.A.A.A.—Federal Alcohol Administration Act.
F.R.—Federal Register.
G.C.M.—Chief Counsel's memorandum (formerly General Counsel's memorandum).
I.R.B.—Internal Revenue Bulletin.
IR-Mim.—Published IR-Mimeograph.
I.T.—Income tax ruling.
M, N, X, Y, Z, etc.—The names of corporations, places or businesses, according to context.
M.T.—Miscellaneous tax ruling.
Mim.—Published mimeograph.
O.D.—Office Decision.
P.L.—Public Law.
P.S.—Pension, profit-sharing, stock bonus or annuity plan ruling.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
R.S.—Revised Statute.
S.M.—Solicitor's Memorandum.
Sol. Op.—Solicitor's Opinion.
S.P.R.—Statement of Procedural Rules.
S.R.—Solicitor's Recommendation.
S.S.T.—Social Security Tax.
S.T.—Sales tax ruling.
Stat.—Statutes at Large.
T.C.—The Tax Court of the United States.
T.D.—Treasury Decision.
TIR—Technical Information Release.
U.S.C.—United States Code.
x and *y* used to represent certain numbers and when used with the word "dollars" represents sums of money.

INTRODUCTION

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for the announcement of official rulings and procedures of the Internal Revenue Service, and for the publication of Treasury Decisions, Executive Orders, tax conventions, legislation, and court decisions pertaining to internal revenue matters. Other items considered to be of general interest are also published in the Bulletin, such as announcements relating to proposed regulations published with notice of proposed rulemaking, announcements relating to decisions of The Tax Court of the United States, announcements of the disbarment and suspension of attorneys and agents from practice before the Treasury Department, supplements to the Cumulative List of Organizations contributions to which are deductible under section 170 of the Internal Revenue Code of 1954, Delegation Orders, etc.

It is the policy of the Service to publish in the Bulletin all substantive and procedural rulings of importance or of general interest, the publication of which is considered necessary to promote a uniform application of the laws administered by the Service. It is also the policy to publish all rulings and statements of procedures which supersede, revoke, modify, or amend any published ruling or procedure. Except where otherwise indicated, published rulings and procedures apply retroactively. Rulings and statements of procedures relating solely to matters of internal management are not published. However statements of internal practices and procedures affecting rights or duties of taxpayers, or industry regulation, which appear in internal management documents, are published. Revenue Rulings and Revenue Procedures are based upon rulings and internal management documents prepared in the various divisions of the National Office, including the Office of the Chief Counsel for the Internal Revenue Service. In the preparation of these, caution is exercised to conceal the identity of the taxpayer, as well as any confidential personal and business information.

Revenue Rulings and Revenue Procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations (including Treasury Decisions), but are published to provide precedents to be used in the disposition of other cases and may be cited and relied upon for that purpose. No unpublished ruling or decision will be cited or relied upon by any officer or employee of the Internal Revenue Service as a precedent in the disposition of other cases.

Since each published ruling represents the conclusion of the Service as to the application of the law to the entire state of facts involved, Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same. In applying rulings and procedures pub-

lished in the Bulletin, personnel of the Service and others concerned must consider the effect of subsequent legislation, regulations, court decisions, rulings, and procedures.

Each published ruling is designated as a "Revenue Ruling," and each published procedure is designated as a "Revenue Procedure." These should be cited by reference to the year of issuance and the Bulletin and page where reported. Thus, Revenue Ruling No. 20 for 1962 should be cited as "Rev. Rul. 62–20, C.B. 1962–1, 21." Similarly, Revenue Procedure No. 4 for 1962 should be cited as "Rev. Proc. 62–4, C.B. 1962–1, 425." Revenue Rulings are keyed to the applicable sections of the Internal Revenue Code and Regulations.

The regulations, rulings, decisions, procedures, etc., published in the weekly Internal Revenue Bulletins 1962–27 through 1962–53 have been consolidated and are published in Internal Revenue Cumulative Bulletin 1962–2.

Internal Revenue Cumulative Bulletin 1962–3 contains the Public Laws pertaining to internal revenue matters enacted during the Second Session of the 87th Congress on or after May 24, 1962, together with their related Committee Reports, and a digest of tax legislation enacted during the Second Session. A topical index to such Public Laws is also included.

Cumulative Bulletin 1962–3 is prepared in three parts, as follows:

I. Part I contains a digest of tax legislation enacted during the Second Session of the 87th Congress (January 1, 1962–December 31, 1962).

II. Part II contains the Public Laws pertaining to internal revenue matters enacted during the Second Session of the 87th Congress on or after May 24, 1962.

III. Part III contains Committee and Conference Reports related to the legislation published in Part II. House, Senate, and Conference Committee Reports printed in the Bulletin do not include the portion entitled "Changes in Existing Law."

PART I

DIGEST OF PUBLIC LAWS

DIGEST OF PUBLIC LAWS ENACTED DURING THE SECOND SESSION OF THE 87TH CONGRESS WHICH PERTAIN TO INTERNAL REVENUE MATTERS

Public laws pertaining to internal revenue matters which were enacted during the second session of the 87th Congress are as follows:

Public law number	Date approved	Digested on page	Public law number	Date approved	Digested on page
	1962			*1962*	
87–403 (H.R. 8847)	Feb. 2	6	87–770 (H.R. 6682)	Oct. 9	12
87–426 (H.R. 641)	Mar. 31	7	87–775 (H.R. 11590)	Oct. 9	52
87–456 (H.R. 10607)	May 24	8	87–790 (H.R. 12180)	Oct. 10	13
87–508 (H.R. 11879)	June 28	8	87–792 (H.R. 10)	Oct. 10	13
87–520 (H.R. 12061)	July 3	51	87–794 (H.R. 11970)	Oct. 11	13
87–535 (H.R. 12154)	July 13	10	87–834 (H.R. 10650)	Oct. 16	15, 50
87–629 (S. 3174)	Sept. 5	51	87–846 (H.R. 7283)	Oct. 22	53
87–682 (H.R. 6413)	Sept. 25	10	87–858 (H.R. 8952)	Oct. 23	44
87–710 (H.R. 12526)	Sept. 28	11	87–859 (H.R. 5260)	Oct. 23	53
87–722 (H.R. 12577)	Sept. 28	11	87–863 (H.R. 10620)	Oct. 23	46
87–734 (H.R. 5144)	Oct. 3	51	87–870 (H.R. 12599)	Oct. 23	48
87–735 (H.R. 5165)	Oct. 3	52	87–876 (H.R. 6371)	Oct. 24	50
87–768 (H.R. 8824)	Oct. 9	12			

The following sections of the Internal Revenue Code of 1954, the Internal Revenue Code of 1939, and the following Public Laws, have been amended by the Public Laws indicated.

INTERNAL REVENUE CODE OF 1954—SECTIONS AMENDED

Code section	Public law number	Public law section	Code section	Public law number	Public law section
11(b)	87–508	2	453(d)(4)(B)	87–834	13(f)(5)(B)
37	87–792	7(a)	461	87–876	3
37(d)	87–876	1	501(c)(15)	87–834	8(d)
38	87–834	2(a)	503	87–792	6
39	87–834	2(a)	521(a)	87–834	17(b)(1)
46	87–834	2(b)	522	87–834	17(b)(2)
47	87–834	2(b)	535(b)	87–403	3(b)
48	87–834	2(b)	535(b)(1)	87–834	9(d)(2)
62	87–792	7(b)	542(c)(7)	87–768	1
72	87–792	4	543	87–403	3(c)
72(f)	87–834	11(b)	545(b)	87–403	3(d)
78	87–834	9(b)	545(b)(1)	87–834	9(d)(2)
101(b)	87–792	7(c)	556(b)	87–403	3(e)
104(a)	87–792	7(d)	561(b)	87–403	3(f)
105	87–792	7(e)	581	87–722	5
162	87–834	3(a)	584	87–722	4
162(a)(2)	87–834	4(b)	591	87–834	6(f)
165	87–426	2(a)	593	87–834	6(a)
167	87–834	13(c)(1)	595	87–834	6(b)
167(e)	87–834	13(b)	613(a)	87–834	13(e)
170	87–834	13(d)	642(e)	87–834	13(c)(2)(A)
170(b)(1)(A)	87–858	2(a)	643(a)(6)	87–834	7(a)
170(b)(1)(B)	87–858	2(b)	665(b)	87–834	7(b)
172	87–710	1	666(a)	87–834	7(c)
172	87–792	7(f)	668(a)	87–834	7(d)
172(b)	87–794	317(b)	669	87–834	7(e)
179(d)(5)	87–834	13(c)(2)(A)	751(c)	87–834	13(f)(1)
179(d)(8)	87–834	13(c)(2)(B)	751(d)(2)	87–834	14(b)(2)
181	87–834	2(c)	801(g)	87–858	3(a)
182	87–834	21(a)	802(a)(2)	87–858	3(b)(1)
213(c)	87–863	1(a)	804(a)(2)	87–858	3(b)(2)
213(g)	87–863	1(b)	805	87–792	7(g)
216	87–834	28(a)	809(b)	87–858	3(b)(3)
245	87–834	5(c)	809(d)(6)	87–790	3(a)
263(a)(1)	87–834	21(b)	809(f)(2)	87–858	3(c)
274	87–834	4(a)(1)	812(e)(2)(B)	87–858	3(d)(1)
281	87–870	1	815(a)	87–858	3(e)
301	87–403	2	815(c)(2)(C)	87–790	3(b)
301	87–834	13(f)(2)	815(c)(3)(B)	87–858	3(b)(4)
301(b)(1)	87–834	5(a)	821	87–834	8(a)
301(d)	87–834	5(b)	821(a)(1)(A)	87–508	2
312	87–403	3(a)	821(b)(1)	87–508	2
312	87–834	14(b)(1)	822	87–834	8(b)
312(c)(3)	87–834	13(f)(3)	823	87–834	8(c)
318(b)	87–834	20(d)(1)	824	87–834	8(c)
341(e)	87–834	13(f)(4)	825	87–834	8(c)
381(c)	87–834	2(d)	826	87–834	8(c)
401	87–792	2	831(a)	87–834	8(e)(1)
401	87–863	2(a)	832(b)(4)	87–834	8(e)(2)
402(a)(2)	87–792	4(c)	832(b)(1)(C)	87–834	8(e)(3)
403(a)	87–792	4(d)	832(c)(11)	87–834	8(e)(4)
404	87–792	3	832(b)(1)	87–834	8(e)(5)
404(a)(2)	87–863	2(b)	831	87–834	8(f)
405	87–792	5	841	87–834	8(g)(1)
453(d)(4)(A)	87–834	13(f)(5)(A)	861(a)(2)(B)	87–834	9(c)

INTERNAL REVENUE CODE OF 1954—SECTIONS AMENDED—Continued

Code section	Public law number	Public law section
901	87–834	12(b)(1)
901(d)	87–834	9(d)(3)
902	87–834	9(a)
904	87–834	10(a)
904(g)	87–834	12(b)(2)
911	87–834	11(a)
951	87–834	12(a)
952	87–834	12(a)
953	87–834	12(a)
954	87–834	12(a)
955	87–834	12(a)
956	87–834	12(a)
957	87–834	12(a)
958	87–834	12(a)
959	87–834	12(a)
960	87–834	12(a)
961	87–834	12(a)
962	87–834	12(a)
963	87–834	12(a)
964	87–834	12(a)
970	87–834	12(a)
971	87–834	12(a)
972	87–834	12(a)
1016(a)	87–834	2(f)
1016(a)	87–834	12(b)(4)
1016(a)(3)	87–834	8(g)(2)
1111	87–403	1
1201(a)	87–834	8(g)(3)
1223	87–834	14(b)(3)
1245	87–834	13(a)
1246	87–834	14(a)(1)
1247	87–834	14(a)(1)
1248	87–834	15(a)
1249	87–834	16(a)
1307(e)	87–834	22(a)
1341(b)	87–863	5(a)
1361	87–792	7(h)
1374(b)	87–834	30
1381	87–834	17(a)
1382	87–834	17(a)
1383	87–834	17(a)
1385	87–834	17(a)
1388	87–834	17(a)
2031(a)	87–834	18(a)(1)
2033	87–834	18(a)(2)(A)
2034	87–834	18(a)(2)(B)
2035(a)	87–834	18(a)(2)(C)
2036(a)	87–834	18(a)(2)(D)
2037(a)	87–834	18(a)(2)(E)
2038(a)	87–834	18(a)(2)(F)
2039	87–792	7(i)
2040	87–834	18(a)(2)(G)
2041(a)	87–834	18(a)(2)(H)
2517	87–792	7(j)
3306(b)(5)	87–792	7(k)
3401(a)(12)	87–792	7(l)
4061	87–508	3(a)
4216(b)(2)(C)	87–858	1(a)
4216(f)(4)(C)	87–770	2(a)
4251(b)(2)	87–508	3(a)
4252(e)	87–508	4(a)
4253	87–508	4(b)
4261	87–508	5(a)
4261	87–508	5(b)
4262	87–508	5(b)
4263	87–508	5(b)
4264	87–508	5(b)
4382(a)(2)	87–834	6(e)(2)
4501(a)	87–456	302(a)
4501(b)	87–456	302(b)
4501(c)	87–535	18(a)
4504	87–456	302(d)
4511	87–456	302(d)
4512	87–456	302(d)
4513	87–456	302(d)
4514	87–456	302(d)
4521	87–456	302(d)
4531	87–456	302(d)
4532	87–456	302(d)
4541	87–456	302(d)
4542	87–456	302(d)
4551	87–456	302(d)
4552	87–456	302(d)
4553	87–456	302(d)
4561	87–456	302(d)
4562	87–456	302(d)
4571	87–456	302(d)
4572	87–456	302(d)
4581	87–456	302(d)
4582	87–456	302(d)
4601	87–456	302(d)
4602	87–456	302(d)
4603	87–456	302(d)
5001(a)(1)	87–508	3(a)
5001(a)(3)	87–508	3(a)
5022	87–508	3(a)
5041(b)	87–508	3(a)
5051(a)	87–508	3(a)
5063	87–508	3(b)
5113(b)	87–863	4(b)
5123(b)	87–863	4(a)
5701(c)(1)	87–508	3(a)
5707	87–508	3(b)
6015(f)	87–682	1(a)
6038	87–834	20(a)
6041	87–834	19(f)
6042	87–834	19(a)
6044	87–834	19(b)
6046	87–834	20(b)
6047	87–792	7(m)(1)
6048	87–834	7(f)
6049	87–834	19(c)
6072(d)	87–834	17(b)(3)
6073(a)	87–682	1(b)
6073(b)	87–682	1(a)
6153(b)	87–682	1(a)

INTERNAL REVENUE CODE OF 1954—SECTIONS AMENDED—Continued

Code section	Public law number	Public law section	Code section	Public law number	Public law section
6412(a)(1)	87-508	3(b)	6654(b)	87-682	1(a)
6412(d)	87-456	302(d)	6654(d)(1)(C)	87-682	1(a)
6412(d)	87-535	18(b)	6677	87-834	7(g)
6416(b)(2)(H)	87-508	5(c)	6678	87-834	19(e)
6418(b)	87-456	302(c)	6679	87-834	20(c)
6421	87-508	5(c)	7207	87-792	7(m)(3)
6501	87-834	2(e)(1)	7511	87-456	302(d)
6501(c)(6)	87-858	3(b)(4)	7515	87-870	3(a)(1)
6501(h)	87-794	317(c)	7516	87-870	3(a)(1)
6511(d)	87-834	2(e)(2)	7608	87-863	6(a)
6511(d)(2)(A)	87-794	317(d)	7701(a)	87-834	7(h)
			7701(a)	87-870	5(a)
6512(b)(2)	87-870	4	7701(a)(19)	87-834	6(c)
6601(e)	87-834	2(e)(3)	7809	87-870	3(b)
6611(f)	87-834	2(e)(4)	7852(d)	87-834	31
6652	87-834	19(d)			

INTERNAL REVENUE CODE of 1939

188	87-834	26

OTHER ACTS

Act and section	*Public law number*
Renegotiation Act of 1951	87-520
War Claims Act of 1958, Section 208(b)	87-846
Section 3 of Public Law 85-235; Public Law 86-37	87-859

Following is a brief explanation of the provisions of the above public laws and the respective Code sections amended thereby. The statements explaining Code sections before amendments and the amendments thereto are not intended as interpretations but are intended merely to indicate the general nature or effect of the provisions involved. Alcohol, tobacco and firearms tax provisions are omitted.

AMENDMENTS TO THE 1954 CODE

PUBLIC LAW 87-403 (C.B. 1962-1, 370).

1111

Return of capital treatment to qualifying shareholders.—Section 1 of this Act amends subchapter O of chapter 1 by adding a new section 1111, the language of which provides, in effect, that in the case of a "qualifying shareholder" of Du Pont or Christiana Securities Company (a 29 percent shareholder of Du Pont) a distribution of General Motors stock required to be divested by such corporations under the Du Pont antitrust decree shall be treated for tax purposes as though neither corporation had any available earnings and profits. Thus, the distribution will not result in a dividend tax nor in a reduction of the earnings and profits of either distributing corporation. Such shareholders will generally receive the GM stock as a return of capital,

paying a capital gains tax on the excess received over their basis of the underlying stock. Section 111(c) voids the "return of capital" relief treatment if one of the principal purposes is the distribution of earnings. The language of section 1111(d), in effect, limits the Act to the Du Pont case by defining the term "antitrust order" so that it coincides only with the time aspects of the Du Pont case. Section 1111(e) defines the stock permitted special tax treatment under the Act in language which, in effect, confines it to GM stock required to be divested by Du Pont or Christiana under the court decree. Under the provision, distribution must be completed within a 3-year period in order for the benefits of the Act to apply.

301(f)

Distribution to corporations parties to the antitrust suit.—Section 2 of the Act provides a new section 301(f), the language of which, in effect, provides that the amount of the distribution by Du Pont to Christiana of GM stock shall be measured by fair market value rather than by the adjusted basis of the stock in the hands of Du Pont as would have occurred under pre-existing law. There is also, in effect, provided under section 301(f)(3) a compensatory adjustment of the basis of the distributed stock in the hands of Christiana in view of the increased amount of the distribution subject to tax.

312(k)

Adjustment of earnings necessitated by section 301(f).—Section 3(a) of the Act amends section 312 by adding a subsection (k), the language of which, in effect, gives the Secretary or his delegate the power to make proper adjustment to the earnings and profits of Christiana when it disposes of the GM stock received as a distribution from Du Pont, to avoid distortion.

535(b)(9), 535(b)(10), 543(a)(1), 543(d), 545(b)(10), 545(b)(11), 556(b)(7), 556(b)(8), 561(b)

Adjustment to special types of income under subchapter G.—Section 3(b) through (f) of the Act amends various sections in subchapter G of the Code, in effect, to ensure that special types of income will receive proper adjustment upon receipt of stock distributions under the Act and subsequent disposal thereof.

These amendments apply with respect to distributions made after February 2, 1962.

Public Law 87–426 (C.B. 1962–1, 374).

165(h)

Disaster loss deduction.—Section 2 of Public Law 87–426 amends section 165 to allow a taxpayer an election to deduct disaster losses for the taxable year immediately preceding the taxable year in which the disaster occurred if the disaster occurred after the close of the taxable year and on or before the time prescribed by law for filing the income return for that year (determined without regard to any extension of time for filing the return). To qualify for this treatment the disaster must have occurred in an area subsequently determined by the President to be an area warranting assistance by Federal

Government under sections 1855–1855(g) of title 42, U.S.C. This amendment is effective with respect to any disaster occurring after December 31, 1961.

PUBLIC LAW 87–456 (page 57).

4501, 4504, 4511, 4512, 4513, 4514, 4521, 4531, 4532, 4541, 4542, 4551, 4552, 4553, 4561, 4562, 4571, 4572, 4581, 4582, 4601, 4602, 4603, 6412(d), 6418(b), 7511

Excise taxes on the manufacture of sugar and the importation of certain items.—Section 302(a) of this Act amends section 4501(a) so as to tax domestically manufactured sugar at 0.53 cent per pound of the total sugar therein. The present tax is levied upon total product weight at rates varying with sugar content. Further, sections 302 (b) and (d) repeal existing excise taxes on imported sugar, the first domestic processing of coconut and palm oil, and on the importation of petroleum products, coal, copper, lumber, animal oils, seeds and seed oils, and manufactures and compounds. These repealed taxes will be assimilated into new tariff schedules to be administered by the Bureau of Customs. The amendment made by section 302(a) will become effective on the tenth day after the date the President issues the proclamation provided for in section 102 of this Act, and the amendments made by sections 302 (b) and (d) are effective with respect to articles entered, or withdrawn from warehouse, for consumption on or after the tenth day following the date of such proclamation.

PUBLIC LAW 87–508 (page 58).

11(b), 821(a)(1)(A), 821(b)(1)

Extension for one year of the existing corporate normal-tax rate.—Section 2 of this Act extends the corporate normal-tax rate of 30 percent for an additional year to July 1, 1963.

4061, 4251(b)(2), 5001(a)(1), 5001(a)(3), 5022, 5041(b), 5051(a), 5063, 5701(c)(1), 5707(a), 5707(b), 6412(a)(1)

Extension for one year of certain excise tax rates.—Section 3(a) of the Act postpones until July 1, 1963, the excise tax rate reductions on the following taxable articles which were to become effective on July 1, 1962: Passenger automobiles, automobile parts and accessories, distilled spirits, imported perfumes containing distilled spirits, cordials and liqueurs containing wine, wines, beer, and cigarettes. This section also postpones the termination of the tax on general telephone service from July 1, 1962 to July 1, 1963. Section 3(b) provides that the floor stock credits or refunds which would have been applicable to all of the taxable articles listed above on hand as of July 1, 1962, except automobile parts and accessories for which no floor stock credit or refund is provided, are postponed for one year. A similar extension to July 1, 1963, is provided in the case of refund for articles from foreign trade zones.

4252(e), 4253

Exemption from communications tax of certain private line services used in the conduct of trade or business.—Section 4(a) of the Act

amends section 4252(e) by redefining wire mileage service so as to exclude from tax amounts paid for wire mileage service which is used in the conduct of a trade or business. Section 4(b) adds subsection (j) to section 4253 to provide an exemption from tax for amounts paid for a telephone or radio telephone line or channel which constitutes general telephone service if such line or channel is furnished between specified locations in different political subdivisions of a State and if the line or channel is used in the conduct of a trade or business. Section 4(c) provides that the amendments made by section 4 (a) and (b) are applicable with respect to communication services furnished on or after January 1, 1963.

4261, 4262, 4263, 4264

Changes in tax on transportation of persons.—Section 5(a) of the Act continues the 10 percent tax on amounts paid for the transportation of persons by rail, motor vehicle, water, or air which begins before November 16, 1962. Prior to the amendment made by section 5(a) this 10 percent rate was scheduled to be reduced to 5 percent on amounts paid on or after July 1, 1962 for such transportation. Section 5(b) amends subchapter C of chapter 33 of the Code so as to repeal the tax on the transportation of persons by rail, motor vehicle, and water with respect to transportation which begins after November 15, 1962, and to continue the tax on the transportation of persons by air at a reduced rate of 5 percent with respect to transportation which begins after November 15, 1962 and before July 1, 1963. The tax on transportation of persons by air is scheduled to be terminated on July 1, 1963. Section 4262 has been amended so as to exclude from taxable transportation, air transportation from one port or station in the United States to another port or station in the United States provided the United States portion is part of "uninterrupted international air transportation." Uninterrupted international air transportation consists of air transportation which does not begin and end in the United States or in the 225-mile zone and (1) the scheduled interval between the beginning or end of the United States portion of such transportation and the end or beginning of the remaining air transportation does not exceed six hours and (2) the scheduled interval between the beginning or end and the end or beginning of any two segments of the United States portion of the transportation does not exceed six hours. Section 4263 also has been amended to eliminate certain exemptions which had application only to transportation by rail, motor vehicle, or water. Section 4264(c) has been amended to provide a special rule relating to the payment of tax in the event the qualifying six-hour scheduled interval for uninterrupted international air transportation is extended beyond six hours subsequent to the beginning of the transportation.

6416(b)(2)(H), 6421(b), 6421(d)(2)

Certain conforming amendments.—Section 5(c) of the Act makes conforming amendments to sections 6416(b)(2)(H), 6421(b) and 6421(d)(2) because of the repeal of the tax on transportation of persons by rail, motor vehicle, or water. Section 5(d) contains the effective dates with respect to the conforming amendments made by section 5(c).

Special credit or refund of transportation tax.—Section 5(e) of the Act contains special provisions for the allowance of a credit or refund in any case where tax on an amount paid for transportation of persons has been collected at the rate in effect before the effective date of the change in tax rate (November 16, 1962 or July 1, 1963) but the transportation does not begin until after such effective date. To be entitled to a credit or refund, the transportation company which collected the tax must establish that the amount of such excess tax has been repaid to the person from whom the tax was collected or consent of such person to the allowance of the credit or refund has been obtained. The repayment must be made or consent obtained before the transportation has begun. Section 5(e) provides that for purposes of this credit or refund transportation shall not be considered to have begun on or after November 16, 1962, or on or after July 1, 1963, as the case may be, if any part of the transportation paid for or for which payment has been obligated commenced before such date.

PUBLIC LAW 87–535 (page 65).

4501(c), 6412(d)

Excise taxes on sugar extended.—Section 18(a) of this Act amends Code section 4501(c) to postpone the termination of excise taxes on the manufacture and importation of sugar from December 31, 1962 to June 30, 1967. Section 18(b) amends section 6412(d) of the Code to provide that floor stock refunds shall be permitted for excise taxes paid on sugar held by importers on June 30, 1967, rather than December 31, 1962, and that claims for such refunds must be filed on or before September 30, 1967, rather than March 31, 1962. (Note: Under Public Law 87–456 approved May 24, 1962, the excise tax on the importation of sugar and the floor stock refunds permitted to sugar importers (section 6412(d)) will be repealed effective on the tenth day after the date of the issuance of a specified Presidential proclamation relating to tariffs.)

PUBLIC LAW 87–682 (page 68).

6015(f), 6073(a), 6073(b), 6153(b), 6654(b), 6654(d)(1)(C)

Extension to fishermen of the same treatment accorded farmers in relation to estimated income tax.—Section 1 of this Act extends to fishermen the same treatment accorded farmers in relation to estimated income tax. The principal advantage to taxpayers having income from farming, which the Act extends to those having income from fishing, is the privilege of filing the declaration of estimated tax, and paying the estimated tax by January 15 of the succeeding taxable year (in the case of a calendar-year taxpayer), rather than filing the declaration by the prior April 15 and making quarterly payments of estimated tax. Taxpayers other than farmers, instead of making their fourth installment payment of estimated tax on January 15 of the succeeding taxable year (in the case of calendar-year taxpayers), are permitted to file their regular income tax return and make their final tax payment by January 31 of the succeeding taxable year. Farmers have until February 15 of the succeeding taxable year to file their regular return and pay their final tax in lieu of filing a declara-

tion and paying the estimated tax by January 15. Under this Act fishermen will also have until February 15 to file their regular return and pay their final tax in lieu of filing a declaration and paying estimated tax by January 15. Section 2 of the Act provides that the amendments to the Code made by section 1 shall apply only with respect to taxable years beginning after December 31, 1962.

PUBLIC LAW 87-710 (page 69).

172

Seven-year net operating loss carryover for regulated transportation corporations.—This Act amends section 172 to provide a 7-year net operating loss carryover (in lieu of the existing 5-year carryover available to all taxpayers) for losses incurred for taxable years ending after December 31, 1955, by a regulated transportation corporation. The term "regulated transportation corporation" includes most corporations (other than pipeline companies) which derive 80 percent or more of their gross income from the furnishing or sale of transportation subject to governmental regulation. Also included are railroad corporations which have leased their railroad properties to another railroad and holding companies for operating railroads. The term also embraces other corporations which are members of an affiliated group which derives 80 percent of its aggregate gross income from the qualified transportation and which file consolidated income tax returns. To qualify for the full 7-year carryover a taxpayer must be a regulated transportation corporation for both the loss year and for the sixth and seventh taxable years following the loss year. There is an apportionment rule provided for losses incurred for taxable years beginning in 1955 and ending in 1956 designed to implement the December 31, 1955, effective date.

PUBLIC LAW 87-722 (page 70).

Rules of general application to banking institutions, relating to definition of bank and definitions pertaining to common trust funds.—This Act authorizes and empowers the Comptroller of the Currency to grant by special permit to national banks applying therefor the right to act in various fiduciary capacities under certain specified conditions. On and after September 28, 1962, the exercise of fiduciary powers by national banks are subject to the authority granted by the Act. Section 3 of the Act repeals subsection (k) of section 11 of the Federal Reserve Act (12 U.S.C. 248(k)).

581, 584(a)(2)

In order to conform the Internal Revenue Code of 1954 to the provisions of the Act, section 4 thereof amends section 584(a)(2) of the Code to add "or the Comptroller of the Currency" after "the Board of Governors of the Federal Reserve System"; and section 5 of the Act amends section 581 of the Code by striking out "section 11(k) of the Federal Reserve Act (38 Stat. 262; 12 U.S.C. 248(k))" and inserting in lieu thereof "authority of the Comptroller of the Currency."

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Public Law 87–768 (page 85).

542(c)(7)

Exceptions to the tax on personal holding companies defined in section 542(a).—In general, section 542(c)(7), prior to this amendment, exempts from personal holding company tax a lending company authorized to engage in the small loan business, if certain other specified requirements are also satisfied. Such other specified requirements include the requirements that the lending company must derive at least 80 percent of its gross income from loans (1) maturing in not more than 36 months; (2) the interest and all other authorized charges on any individual loan must not exceed the amount equal to simple interest computed at the rate of 3 percent per month not payable in advance and only on unpaid balances; and (3) at least 60 percent of its gross income must be derived from loans to individuals each of whose indebtedness to the company does not exceed the limit prescribed by applicable State law or, if there is no such limit, $500. This Act amends section 542(c)(7) so as to delete the requirements in items (1) and (2) mentioned in the preceding sentence and increases the $500 limitation mentioned in item (3) to $1,500. In addition, section 542(c)(7) is amended so that the 80 percent of gross income need not be derived solely from loans but also may include lawful income received from domestic subsidiaries (in which the corporation has at least 80 percent of the voting power of all classes of stock and owns at least 80 percent of the nonvoting stock) if the subsidiaries are themselves exempted from personal holding company tax under sections 542(c) (6), (7), (8), or (9). The amendment also makes clear that the term "small loan business" includes a "consumer finance business" so as to encompass consumer finance loans generally; and require that the organization be not only "authorized" to engage in the small loan or consumer finance business but must also be "actively and regularly engaged in" such business. The amendment applies with respect to taxable years beginning after December 31, 1961.

Public Law 87–770 (page 86).

4216(f)(4)(C)

Addition of magazines and outdoor advertising signs and posters as media of local advertising charges for which may qualify for exclusion from sale price for purposes of manufacturers excise taxes.—Section 4216(f)(4) of the Code contains a definition of the term "local advertising" for purposes of the exclusion of charges for local advertising from the sale price of taxable articles. Subsection (C) of section 4216(f)(4) limits the advertising to that which is broadcast over a radio or television station or appears in a newspaper. Section 2 of this Act amends section 4216(f)(4)(C) to add magazines and outdoor advertising signs and posters as qualifying advertising media for purposes of this exclusion. This amendment applies with respect to articles sold on or after January 1, 1963.

Public Law 87–790 (page 88).

809(d)(6), 815(c)(2)(C)

Life Insurance Company Deduction for Certain Accident and Health Insurance and Group Life Insurance Contracts.—Section 3 of this Act amends section 809(d)(6) (relating to the deduction for group life, accident and health insurance) and section 815(c)(2)(C) (relating to the policyholders surplus account) by extending the deduction to individual as well as group accident and health insurance contracts and group life insurance contracts. These amendments are applicable to taxable years beginning after December 31, 1962.

Public Law 87–792 (page 89).

37(c), 62(7), 72(d), 72(m), 72(n), 101(b), 104(a), 105(g), 172(d), 401(a), 401(c), 401(d), 401(e), 401(f), 401(g), 402(a), 403(a), 404(a), 404(e), 404(f), 405, 503(j), 805(d), 1361(d), 2039(c), 2517(a), 2517(b), 3306(b), 3401(a), 6047, 7207

SELF-EMPLOYED INDIVIDUALS TAX RETIREMENT ACT OF 1962

Under the provisions of the Act self-employed individuals may establish pension or profit-sharing plans covering themselves. Contributions to the plan are deductible and income earned by the plan is not taxed until withdrawal from the fund. An owner-employee, however, cannot be covered by the plan unless all full-time employees with more than 3 years service are covered. An owner-employee is one who owns all of an unincorporated business or is a partner owning more than a 10-percent interest in the capital or profits of the business. For each taxable year a self-employed individual, whether or not an owner-employee, may deduct one-half the deductible contributions made for his own benefit. These contributions are limited to the lesser of $2,500 or 10 percent of "earned income," the maximum deduction being $1,250. If other employees are covered by the plan, a self-employed individual may also make additional nondeductible contributions on the same basis as the other employees. In the case of owner-employees, however, these additional contributions are also limited to the lesser of $2,500 or 10 percent of earned income. "Earned income" generally means professional fees and other compensation for personal services. Where invested capital is a material income-producing factor, the term means not more than 30 percent of the net profits of the business, but, when the self-employed person renders full-time personal services, not less than the first $2,500 of the net profits shall be considered "earned income." Plans covering owner-employees must also provide that contributions for all employees are nonforfeitable when made; that benefits to owner-employees must not be paid before age 59½, except in case of death or permanent disability; and that distribution to owner-employees must begin by age 70½. Lump-sum distributions to self-employed individuals are subject to an averaging provision, but other employees receive capital gains treatment.

The trustee of a pension or profit-sharing trust benefiting owner-employees must be a bank or other specified financial institution, unless annuity, endowment, or life insurance contracts are used exclusively

to fund the trust. Custodial accounts with banks may be used, or the plan may be funded by the direct purchase of a new series of Government bonds. Income realized on the redemption of these special bonds, however, is always taxed at ordinary rates and a lump-sum distribution under a qualified bond plan does not result in capital gains treatment for any employee. Integration with social security is allowed, subject to certain restrictions. Penalties are provided for excess contributions, premature distributions, and engaging in certain prohibited transactions.

Self-employed individuals do not qualify either for the $5,000 death benefit exclusion or for the sick-pay exclusion, nor do they qualify for the estate and gift tax exclusion generally allowed to employees under qualified plans. A self-employed individual may exclude from his gross income, however, amounts received through accident or health insurance to the extent attributable to his own nondeductible contributions. Distributions to self-employed individuals under qualified plans qualify as retirement income for purposes of the retirement income credit.

The Act also amends the Code with regard to existing plans to provide that the rights of all covered employees must vest when the plan terminates or contributions cease and that forfeitures under a pension plan may not be used to increase the benefits that any employee would otherwise receive.

For purposes of the Federal unemployment tax and the withholding of income tax from wages, the Act provides an exclusion from wages for payments under or to an annuity plan described in section 403(a) or a qualified bond purchase plan described in section 405(a). These exclusions supersede the existing exclusion from such wages for payments under or to employee annuity plans which meet the requirements of section 401(a) (3), (4), (5), and (6). The Act does not affect the taxes under the Federal Insurance Contributions Act.

The amendments made by this Act apply to taxable years beginning after December 31, 1962.

Public Law 87–794 (page 107).

172, 6501(h), 6511(d) (2) (A)

TRADE EXPANSION ACT OF 1962

Extended net operating loss carryback for taxpayers injured by increased imports.—The Trade Expansion Act of 1962 provides several forms of adjustment assistance for firms certified to be eligible because of serious injury by increased imports resulting from trade agreement concessions. Section 317 of this Act amends section 172 by extending the period to which a net operating loss may be carried back, from 3 years to 5 years, for a firm certified for tax assistance by the Secretary of Commerce. Prior to certification, the Secretary of Commerce is to determine that tax assistance will materially contribute to the economic adjustment of the firm, and if the firm carries on more than one trade or business, the Secretary of Commerce must further determine that the loss arose predominantly out of carrying on the import-injured trade or business. The firm is to apply to the

Secretary of Commerce for tax assistance within 24 months after the close of the loss year and is to notify the Service that it has filed the application. After issuance of the certification, by the Secretary of Commerce, the firm is to file a copy with the Service and must also consent in writing to the assessment of a deficiency for any year attributable to the disallowance of a deduction already allowed for the same net operating loss under the usual net operating loss rules. The 5-year carryback will apply only for net operating losses incurred in taxable years ending on or after December 31, 1962. The carryback period for a net operating loss of a partner or a shareholder in a subchapter S corporation is extended to 5 years only if the net operating loss of the taxpayer is predominantly attributable to certified losses. With respect to amounts attributable to a loss for which a certification has been issued, the period for assessing a deficiency is not to expire before 18 months after the taxpayer files a copy of the certification with the Service, and the period for claiming credit or refund is not to expire before 6 months after the certification is issued.

Public Law 87–834 (page 111).

38, 46, 48, 181, 1016

REVENUE ACT OF 1962

Credit for investment in certain depreciable property.—Under new section 38, a taxpayer's income tax liability will be reduced by a credit for investment in certain depreciable property. The new investment credit is not merely a deduction allowed in computing income on which tax is imposed; rather, it is a credit against the income tax imposed. New section 38 (section 38 of prior law was redesignated section 39) provides that the amount of the credit is to be determined under sections 46, 47, and 48.

Under new section 46, the credit is 7 percent of the "qualified investment" in "section 38 property" placed in service during a taxable year ending after December 31, 1961. In the case of public utility property, the effective rate of the credit is three percent. Section 38 property is tangible personal property, and certain real property, which is depreciable property having a useful life of 4 years or more, and which is acquired or constructed after December 31, 1961. Real property that may qualify is property (other than a building) used as an integral part of manufacturing, production, extraction, or certain public service activities, and research or storage facilities used in connection with any of the enumerated activities. Section 38 property does not include buildings, livestock, most property used outside the U.S., property used in furnishing lodging (other than by a hotel or motel), and property used in tax-exempt activities. Section 38 property may be either new or used, but not more than $50,000 of investment in used property will qualify for the credit. In general, "qualified investment" in section 38 property is determined by multiplying the basis of the property (or the cost in case of used property) by 100 percent if the useful life of the property is 8 years or more, 66⅔ percent if the useful life is 6 but less than 8 years, and 33⅓ percent if the useful life is 4 but less than 6 years.

The investment credit allowed for any year is subject to a limitation based on the taxpayer's liability for tax (as defined in section 46(a)) for that year. The credit may never exceed the tax liability, nor may it exceed an amount equal to $25,000 of tax liability plus 25 percent of the tax liability over that amount. Special rules govern the applicability of this $25,000 amount in the case of certain married persons filing separate returns, affiliated groups, and certain special taxpayers such as mutual savings banks, etc.

The amount of the credit which exceeds the limitation may be carried back three years (but not to a year ending before January 1, 1962) and forward five years. For purposes of depreciation, and gain or loss, the basis of qualified property is reduced by an amount equal to 7 percent of the qualified investment in the property. This basis adjustment is not made for purposes of computing the investment credit. A deduction is allowed under new section 181 for any investment credit unused either at the end of the five-year carryover period or upon death or cessation of existence of the taxpayer. In general, a lessor of new property may make an election permitting the lessee to take the credit. If the lessor makes the election, the credit is computed by reference to the useful life and the basis of the property in the hands of the lessor. If the property was constructed by the lessor, the credit is computed by using the fair market value of the property. No basis adjustment is necessary where the lessee is allowed the credit, but the lessee, in computing his taxable income, must reduce his deductions for rent by an amount equal to the credit.

47

New section 47 requires a recomputation of the investment credit (with certain limited exceptions) when property on which the credit was allowed is disposed of or otherwise ceases to qualify as section 38 property before the expiration of the period claimed as the estimated useful life of the asset in the computation of the credit. The credit is recomputed by using the actual period the property was held rather than the estimated useful life assigned to the property in the original computation. Any reduction in the investment credit first affects any carryovers of unused investment credits and then may result in the imposition of additional tax for the year of disposition. No recomputation is necessary in case of a transfer by reason of death, transfers in certain corporate acquisitions, or certain changes in the form of doing business (such as incorporation of a sole proprietorship).

381(c)

Section 381(c) is amended by adding thereto a new paragraph (23) to provide for the carryover in certain corporate acquisitions of the investment credit attributes of the transferor corporation.

6501, 6511, 6601, 6611

The statutory provisions relating to statutes of limitations and interest have been amended to permit orderly administration of the 3-year unused investment credit carryback provision.

162(e)

Appearances, etc., with respect to legislation.—Under prior law expenses in connection with any legislative activities were nondeductible

as was that portion of any dues paid to an organization which was attributable to such activities, if a substantial part of the organization's activities consisted of legislative activities. This was so even though such expenses might otherwise be ordinary and necessary business expenses. New section 162(e), as added by section 3 of the Act, permits a deduction for certain legislative expenses if they are ordinary and necessary business expenses and if they are concerned with legislation or proposed legislation of direct interest to a taxpayer (or an organization of which he is a member). A deduction will be allowed for such expenses which are directly connected with: appearances before, submission of statements to, or sending communications to individual legislators, committees, or legislative bodies of all levels of government; and, the communication of information between a taxpayer and an organization of which he is a member (or vice versa). Dues paid by a business taxpayer to an organization engaging in the foregoing activities are deductible to the extent attributable thereto. However, no deduction will be allowed for: any amount paid or incurred for participation or intervention in a political campaign in support of or in opposition to, any candidate; and, any expenditure to influence the general public, or segments thereof (by advertising or otherwise), with respect to legislative matters, elections, or referendums (e.g., so-called grassroot campaigns). This provision shall apply to taxable years beginning after December 31, 1962.

274, 162(a)(2)

Disallowance of certain entertainment, etc., expenses.—Section (4) of this Act amends subchapter B of chapter 1 of the Code by adding a new section 274 which disallows in whole or in part certain expenses which were fully deductible under prior law. The requirements imposed are in addition to the requirements for deductibility under sections 162 and 212. Section (4) also amends section 162(a)(2) with respect to travel expenses.

Under prior law entertainment and related expenses were deductible if they were shown to be ordinary and necessary in the carrying on of the taxpayer's trade or business. Under new section 274(a) no deduction is allowed for entertainment expenses unless the taxpayer establishes that the expense was directly related to the active conduct of his trade or business, except that entertainment which directly precedes or follows a substantial and bona fide business discussion is deductible if it is associated with the active conduct of his trade or business. No deduction is allowed for expenses with respect to entertainment facilities, including club dues, unless the taxpayer establishes that the facility was used primarily for the furtherance of the taxpayer's trade or business and that such expense was directly related to the active conduct of his trade or business.

The disallowance provisions of new section 274(a) do not apply to certain categories of expenses (set forth in new section 274(e)), which might be considered to constitute entertainment, such as certain business meals, employee recreation, employee and stockholder business meetings, etc. However, such expenses must be substantiated.

Generally under prior law the cost of a business gift was deductible by the donor if it was shown to be ordinary and necessary in the carry-

ing on of the donor's trade or business. Under new section 274(b) gifts deductible under prior law are limited to $25 per recipient per year but the following items are excluded from this limitation:

(1) certain advertising specialty gifts costing the donor $4 or less;

(2) certain advertising material used on the business premises in connection with the recipient's business: and

(3) certain employee awards costing $100 or less.

Under prior law traveling expenses away from home (including the entire amount spent for meals and lodging) were deductible if the primary purpose of the trip was connected with business. New section 274(c) requires an allocation of the expenses to and from one's destination where the trip is for both business and pleasure. The non-business portion of the allocation is not deductible. No such allocation is required, and the primary purpose test of prior law applies, where the trip is for 1 week or less, or if the trip exceeds 1 week and less than 25 percent of the time spent is unrelated to business. Also section 162(a)(2) is amended to disallow the portion of expenses for meals and lodging incurred while traveling away from home in pursuit of a trade or business which is considered to be lavish or extravagant.

Under prior law where travel, entertainment, gifts and related expenditures were not substantiated but there was evidence that some expenditures were made, the courts, using the rule of the George M. Cohan case, have allowed a deduction for what was determined to be a reasonable approximation of such expenditures. New section 274(d) supersedes the Cohan rule and requires all taxpayers to substantiate such expenditures in detail by adequate records or by sufficient evidence corroborating their own statements in order to obtain a deduction for such expenditures.

The new provisions apply with respect to taxable years ending after December 31, 1962, but only in respect of periods after such date.

301(b)(1)(C)

Certain corporate distributees of foreign corporation.—Section 5(a) of this Act amends section 301(b)(1) of the Code by adding a new subparagraph (C) which provides that property (other than money) distributed by a foreign corporation to a corporate shareholder is to be taken into account at its fair market value. A partial exception is made, however, to this rule when a deduction with respect to such a distribution is allowable under section 245 (relating to 85 percent dividends received deduction on income from United States sources). In the latter case, the amount taken into account is determined by an apportionment based on the lower of adjusted basis or fair market value of the property to the extent the distribution is attributable to income from United States sources and on the fair market value of the property to the extent the distribution is attributable to income from sources without the United States. This amendment applies to distributions made after December 31, 1962.

301(d)(3)

Basis of certain corporate distributees of foreign corporation.—Section 5(b) of this Act amends section 301(d) by adding a new paragraph (3) which provides that the basis of property received by

corporate shareholder from a foreign corporation is determined under new subparagraph (C) of section 301(b)(1). This amendment applies to distributions made after December 31, 1962.

245(b)

Distributions of property received from certain foreign corporations.—Section 5(c) of this Act amends section 245 by designating existing section 245 as subsection (a) and adding new subsection (b) which provides that for purposes of computing the dividends received deduction under section 245(a), the amount of the distribution of property other than money is to be determined by applying the existing rule of section 301(b)(1)(B). This amendment applies to distributions made after December 31, 1962.

593

Reserves for losses on loans of mutual savings institutions.—Section 6(a) of the Act provides new rules for the calculation of additions to the reserves for bad debts of mutual savings institutions. The institutions subject to these rules are (i) mutual savings banks not having capital stock represented by shares, (ii) domestic building and loan associations, and (iii) cooperative banks without capital stock organized and operated for mutual purposes and without profit. Beginning in 1963, the allowable deduction for additions to reserves for bad debts is the sum of two amounts—an amount added to a reserve for losses on nonqualifying loans and an amount added to a reserve for losses on qualifying real property loans. Qualifying real property loans are defined as any loan secured by an interest in improved real property or by real property which is to be improved out of the proceeds of the loan, providing the loan is (i) not evidenced by a security (as defined in section 165(g)(2)(C), (ii) not the primary obligation of a government, bank, or affiliated organization, (iii) not secured by a deposit or share of the institution, or (iv) not acquired and disposed of within a 60-day period. Nonqualifying loans are all other loans.

The addition to the reserve for losses on nonqualifying loans is an amount determined under section 166(c) to be a reasonable addition based upon the amount of loans outstanding, the amount already in the reserve, the experience of the institution and other appropriate factors.

The addition to the reserve for losses on qualifying real property loans is any amount determined by the taxpayer to be a reasonable amount, but such amount may not exceed the largest of three amounts, computed under three different methods, as follows:

(1) *Percentage of taxable income method.*—Sixty percent of taxable income (computed without regard to any bad debt deduction, and without regard to any amount added by reason of a distribution with respect to nonwithdrawable shares) reduced by the addition to the nonqualifying reserve. However, the addition under this method may not result in increasing the reserve to more than 6 percent of qualifying loans.

(2) *Percentage of real property loans method.*—An amount necessary to increase the reserve to 3 percent of qualifying loans. Mutual companies which are less than 10 years old may build

reserves to 5 percent of the first $4,000,000 of their qualifying loans and 3 percent of loans in excess of $4,000,000 unless they have any amount in the supplemental reserve for losses on loans (see below).

(3) *Experience method.*—An amount determined under section 166(c) (without regard to section 593) to be a reasonable addition to the reserve.

Unless the addition to the qualifying reserve is computed under the experience method, the addition, when added to the addition to the nonqualifying reserve, may not exceed the maximum addition which could have been made under former section 593. Former section 593 provided that the addition to the reserve could not exceed the amount by which 12 percent of deposits or withdrawable accounts at the close of the year exceeds the sum of the surplus, undivided profits, and reserves at the beginning of the year.

In the case of certain savings and loan associations whose assets of the type described in section 7701(a)(19)(D)(ii) exceed 36 percent of the total assets, the addition under the percentage of taxable income method and the percentage of loans method shall be reduced by ½ thereof respectively for each percentage point (or fraction thereof) in excess of 36 percent but less than 42 percent.

Provision is made for the allocation of reserves accumulated before 1963 in the reserve for bad debts to the nonqualifying reserve and the qualifying reserve on the basis of amounts which would have been accumulated if the institution had been making additions under the experience method or the percentage of loans method of the new law (whichever would have produced the larger reserve). Any excess is allocated to a supplemental reserve for losses on loans. The latter reserve is treated as a bad debt reserve, but it is not taken into account in determining additions to the two other reserves except in the case of new institutions which might claim amounts to build the qualifying reserve up to 5 percent of the first $4,000,000 of qualifying loans. Amounts accumulated before 1952 will not be allocated to the three reserves except to the extent that post-1951 accumulations are not sufficient to increase the qualifying reserve to 3 percent of loans or a reasonable amount, if greater. When so allocated, the pre-1952 reserves will be considered solely for the purpose of computing future additions to the qualifying reserves.

Although the bad debt provisions of the Act are effective for taxable years ending after December 31, 1962, a special provision relating to fiscal years beginning in 1962 and ending in 1963 has the effect of applying the old law to the portion of the taxable year falling in 1962 and the new law to the portion of the taxable year falling in 1963.

Special rules relating to distributions of property made with respect to nonwithdrawable accounts provide for the order of charging distributions and for the determination of the amount so charged.

595

Foreclosure on property securing loans.—Section 6(b) of the Act changes existing rules where a mutual savings institution (referred to in section 593) bids in real property on foreclosure, or otherwise re-

ceives, pursuant to agreement or process of law, real property which was security for a loan. The new rules, effective for transactions occurring after December 31, 1962, provide that no gain or loss and no bad debt shall be recognized as a result of foreclosure. The foreclosed property shall acquire the basis of the debt and be treated as the debt. Amounts realized with respect to the property shall be treated as payment on account of the loan, and, upon ultimate disposition, any loss shall be treated as a bad debt.

7701(a)(19)

Definition of domestic building and loan association.—The general definition of "domestic building and loan association" in section 7701 (a)(19) is changed to require that, for years beginning after October 16, 1962, an association meet three types of tests. One test provides that the savings association must either have its accounts insured by the Federal Savings and Loan Insurance Corporation or be subject by law to supervision and examination by State or Federal authority. The second test requires that substantially all the business of the association must consist of acquiring the savings of the public and investing in real estate loans and certain assets closely associated with such business. The third test is a series of percentage requirements which sets forth the minimum percentages of assets which must consist of certain types of loans. In general, real estate mortgage loans are most favored under these requirements, with special emphasis on mortgages given on property containing 1 to 4 family units. In certain situations an institution may deviate from one of the percentage requirements for a year by up to 5 percentage points. (But the special deduction for additions to the reserve for bad debts under the percentage of taxable income method or the percentage of real property loans method is reduced.)

591

Deduction for dividends paid on deposits.—Dividends or interest paid on deposits or withdrawable accounts by savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law are deductible even though they do not come within the definition of domestic building and loan associations.

Repeal of exemption of Federal savings and loan associations from Federal taxes.—Section 6(e)(1) of this Act amends section 5(h) of the Home Owner's Loan Act of 1933 so as to eliminate entirely the exemption previously accorded Federal savings and loan associations from those Federal taxes, the legal incidence of which would fall upon them. These Federal taxes include, among others, the excise taxes on amounts paid for communication services and for the transportation of persons. In the case of the tax on communication services this amendment is effective with respect to amounts paid pursuant to bills rendered after December 31, 1962, and in the case of the tax on the transportation of persons the amendment is effective with respect to transportation which begins after December 31, 1962.

4382(a)(2)

Amendment of exemption from documentary stamp tax for domestic building and loan associations.—Section 6(e)(2) amends Code

section 4382(a)(2) to limit the Federal documentary stamp tax exemption now available to domestic building and loan associations (as defined in paragraph 19 of section 7701(a) as amended by section 6(c) of this Act) and cooperative banks to shares or certificates of stock issued by such associations and banks which represent deposits or withdrawable accounts. Thus, the exemption will not apply to shares or certificates of stock issued by such associations and banks which represent their capital stock or to certificates of indebtedness issued by these associations and banks. The amendment made by section 6(e)(2) is effective January 1, 1963.

643(a)(6), 643(d), 665, 666(a), 668(a), 669, 6048, 6677, 7701(a)(30), 7701(a)(31)

Distributions by foreign trusts.—Under the law prior to this amendment foreign trusts could be established for the benefit of U.S. beneficiaries by U.S. grantors or settlors in such a way that little or no tax on the foreign trust's income would be paid to the United States. Section 7 of the Act amends several sections of the Code in order to tax U.S. beneficiaries of foreign trusts to which U.S. persons have transferred money or property in approximately the same manner as if the income had been distributed to the beneficiary currently as earned. Only that portion of a foreign trust which was created by a United States person or to which a U.S. person transferred property, will be affected by these new provisions. Section 643, relating to definitions for estates and trusts, is amended to provide special rules for foreign trusts, the most important one being that in computing the distributable net income of a foreign trust, any excess of capital gains over capital losses shall be taken into account. Section 665, relating to definitions concerning the treatment of excess distributions by trusts, is amended to provide that an accumulation distribution, in the case of a foreign trust created by a U.S. person, is any distribution in excess of current distributable net income. Under section 666, as amended, the restriction of the throwback rule to the 5 preceding taxable years of the trust is removed for foreign trusts created by a U.S. person. Instead an unlimited throwback is provided, applying however only to years governed by the 1954 Code. Section 669, a new section relating to special rules applicable to certain foreign trusts, is added to subchapter J of chapter 1. It provides special rules relating to the treatment of excess distributions by foreign trusts created by U.S. persons. If the beneficiary furnishes certain information relating to the operation and accounts of the foreign trust, he may elect to compute his tax liability under either of two methods. If these methods are not elected, he must compute his liability in the ordinary way by including in income the entire amount of an accumulation distribution. The first method, known as the "exact method," is similar to that provided for domestic trusts except the restriction of the throwback rule to the 5 preceding taxable years has been removed and replaced by an unlimited throwback. The second method, known as the "short-cut method," in effect averages the tax attributable to the distribution over the same number of years which equal the number in which the income was earned by the trust. An average amount is included in the ben-

eficiary's income for the current year and each of the two immediately preceding years. From these three years the average additional tax for one year is determined and then multiplied by the number of years of the total accumulation. The new section specifies how the beneficiary may change from one method to the other and provides other rules for situations where the new methods must be adjusted to fit the unusual facts of a particular distribution. The Act also adds two new sections to the Code relating to information returns and penalties for failure to file them. New section 6048 requires that a United States person who either creates a foreign trust or transfers money or property to a foreign trust must file an information return and new section 6677 provides a civil penalty for those persons who fail to file the return required by section 6048, unless it is shown that such failure is due to reasonable cause.

821, 822, 823, 824, 825, 826, 831, 832

Taxation of mutual fire and casualty insurance companies.—Section 8 of this Act amends Part II of subchapter 6 of chapter 1 of the Code to provide that mutual fire and casualty insurance companies, previously subject to a tax either on net investment income or gross investment income and premiums, shall be subject to a tax upon a total income base at ordinary corporate rates. Mutual insurance company taxable income is to be comprised of investment income and statutory underwriting income. Certain small companies with total receipts not exceeding $150,000 are tax exempt. Those companies with gross receipts between $150,000 and $500,000 are taxed at corporate rates only on investment income. Those companies with total receipts not exceeding $1,100,000 receive a diminishing $6,000 special deduction against underwriting income. This special deduction vanishes when total receipts equal $1,100,000. A special transitional rule applies to companies which experienced underwriting losses in years prior to 1962.

Statutory underwriting income is underwriting income less a special deduction consisting of one percent of the year's incurred losses and 25 percent of the year's underwriting income. The special deduction amounts are set aside in a protection against loss account for a five-year period to be available to pay extraordinary losses. If not absorbed by such losses within five years, a portion of the amount set aside is then taxed as underwriting income and the balance remains permanently in the protection against loss account to pay any extraordinary losses. Losses exceeding investment income and amounts in the protection against loss account are treated like net operating loss carrybacks and carryovers. Special treatment concerning the size of protection against loss accounts is given companies underwriting certain windstorm risks.

Reciprocal underwriters, previously taxed only upon investment income exceeding $50,000, are now taxed like other mutuals. In addition they may elect to take a credit for taxes paid by their attorney-in-facts. Factory mutuals, in the past treated as mutuals, are now taxed as though they are stock companies. Mutual marine companies, previously taxed as stock companies, will continue to be taxed like stock companies.

These amendments apply to taxable years beginning after December 31, 1962.

78, 902(a), 902(b), 902(c), 902(d), 902(e), 861(a)(2)(B)

Foreign tax credit gross-up of dividends.—In general, prior to section 9 of this Act, a domestic corporation (owning 10 percent or more of the stock of a foreign corporation) was permitted a partial double allowance for foreign taxes paid by its subsidiary with respect to the dividends distributed. This resulted from the fact that the foreign taxes were excluded from the income of the parent, as dividends are paid on an after-tax basis, and a partial credit was also allowed under section 902 for the same foreign taxes to the extent applicable to the actual distribution.

Section 9 of this Act adds a new section 78 to provide, in effect, that if a domestic corporation elects to take a credit (rather than a deduction) for taxes paid by a foreign subsidiary (other than a less developed country corporation) it must, in addition to the dividend received, take into income the foreign taxes paid with respect to the profits on which such dividend was distributed, that is, gross-up the dividends received. The amendment to section 902 provided by this Act, in effect, allows as a foreign tax credit (within existing limitations) the foreign tax paid on this "grossed-up" amount (the total arrived at under section 78), rather than only that tax which is allocable to the actual dividend under the rule enunciated by the court in the *American Chicle Company* case, 316 U.S. 450 (1942).

This section, by repealing section 902(d), discontinues the treatment of certain royalties paid in lieu of dividends, as dividends for the purpose of the foreign tax credit.

Section 861(a)(2)(B) has also been amended by this section to treat as U.S. source income the 15 percent of the dividends remaining in income after taking the 85-percent dividends received deduction which is available, under certain circumstances, to a domestic parent where its foreign subsidiary had U.S. source income. The amendment changes the present rule which permitted this 15-percent excess to be treated as foreign source income for the purpose of limitations on the foreign tax credit.

These amendments apply in respect of any distributions received after December 31, 1964. They also apply to distributions received before January 1, 1965, but only to the extent they are made from the accumulated profits of the subsidiary for its taxable years beginning after December 31, 1962.

904

Separate limitation on foreign tax credit with respect to certain interest income.—Section 10 of this Act amends section 904, relating to limitations on the foreign tax credit, by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) a new subsection (f) relating to special rules in case of interest income. Under section 904, an unused foreign tax credit results when the foreign rate of tax is higher than the U.S. rate on the same income. To offset this unused foreign tax credit, U.S. taxpayers often transfer short-term capital abroad to countries where the interest income from the investment will be taxed at a rate lower than the U.S. tax on

such income. New subsection (f) provides that the limitation on the foreign tax credit is to be applied separately to certain interest income as opposed to the rest of a taxpayer's income and further provides that the limitation with respect to the interest income always must be applied on a per-country basis. The provision is made applicable to all interest income, except interest—(1) derived from transactions directly related to the active conduct of a trade or business in a foreign country or U.S. possession; (2) derived in the conduct of a banking, financing, or similar business; (3) received from a corporation in which the taxpayer owns at least 10 percent of the voting stock; (4) and interest received on obligations acquired where it was necessary to dispose of an active trade or business carried on in a foreign country or United States possession or to dispose of securities in a foreign subsidiary corporation in which the taxpayer has had at least a 10 percent voting interest. Transitional rules are provided for computing carrybacks and carryovers where any year involved is a year to which the new provision is not applicable. The new subsection applies with respect to taxable years beginning after the date of enactment of the Act but only with respect to interest resulting from transactions consummated after April 2, 1962.

Earned income from sources without the United States.—Section 11 of this Act amends section 911, relating to taxability of earned income from sources without the United States, by placing an additional limitation on the amount of earned income which certain United States citizens living abroad may exclude from their gross income. In general, section 911, prior to this amendment, provided that an individual citizen of the United States who is a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year may exclude from his United States tax base his entire earned income from sources outside of the United States. In addition an individual who lives abroad, but does not establish a foreign residence, may exclude from his United States tax base his earned income up to $20,000 a year if he remains abroad for a period of 17 out of 18 consecutive months. Under the new provision, the exemption for bona fide residents of foreign countries will be limited to $20,000 a year for the first 3 years, the same limitation as for those physically present abroad for a period of 17 out of 18 consecutive months. After a bona fide resident has been abroad for 3 consecutive years, the limitation is raised to $35,000. Prior law is also changed by providing that amounts received shall be considered received in the taxable year in which the services to which the amounts are attributable are performed. However, no amount may be excluded under either limitation unless it is received before the close of the taxable year following the taxable year in which the services were performed. Regarding the treatment of earned income which is held to be community property under local law, the statute now provides that the aggregate amount excludable under either limitation from the gross income of a husband and wife shall equal the amount which would be excludable if the income did not constitute community income. There are 2 provisions in section 11 which relate to pensions and annuities. The first provides that no amount received as a pension or annuity may be excluded under either limitation. The second

relates to amounts contributed by an employer to certain nonqualified pension plans. It provides that where amounts must be included in an employee's gross income under sections 402(b), 403(c), and 403(d), they may not be excluded by reference to section 911. A new provision in section 911 now provides that if an individual asserts and is held not subject to foreign income tax by the foreign authorities concerned on the grounds that he is not a resident of the country involved, this shall be conclusive evidence that he is not a bona fide resident of such country for purposes of section 911(a)(1), relating to bona fide residence. Another provision relating to fringe benefits which are noncash in nature, such as the use of a home or car, states that these fringe benefits will be entirely excluded from taxable income for a taxable year ending in 1963, excluded to the extent of two-thirds for years ending in 1964, and excluded to the extent of one-third for years ending in 1965. After 1965, these amounts must be included in gross income to the extent that they, together with any other income earned from foreign sources, exceed the applicable limitation. In general, the amendments to section 911 are effective with respect to all amounts received after March 12, 1962, which are attributable to services performed after December 31, 1962. They also apply to amounts received after December 31, 1962, which are attributable to services performed on or before December 31, 1962, unless there existed a right to receive such amounts on March 12, 1962.

Section 11 of this Act also amends section 72(f), relating to special rules for computing employee's contributions in connection with annuities. The amendment changes prior law by providing that, in general, amounts contributed after December 31, 1962, to a plan by an employer no longer shall be considered as part of the employee's contribution by reason of the application of section 911 unless the services were performed before January 1, 1963. This amendment to section 72 is effective for taxable years ending after December 31, 1962.

Controlled foreign corporation.—Section 12 of this Act amends the Code by adding subparts F (sections 951–963) and G (sections 970-971) to Part III of subchapter N of chapter 1 (relating to income from sources without the United States). Prior to this amendment profits earned by foreign corporations were not taxed to United States shareholders until they were distributed as dividends. This section of the Act provides that certain types of income of foreign corporations controlled by United States shareholders are included in income of such shareholders in the year the income is earned, whether or not distributed.

951

Amounts included in gross income of United States shareholders.—Section 951 provides that if a foreign corporation is a controlled foreign corporation, hereafter termed CFC (as defined in section 957), for at least 30 consecutive days during its taxable year, then every United States shareholder who owns stock in such corporation on the last day in such year on which the corporation is a CFC must include:

1. His prorata share of the CFC's subpart F income (as defined in section 952),

2. His prorata share of the CFC's previously excluded subpart F income withdrawn from investment in less developed countries (as determined in section 955), and

3. His prorata share of the CFC's increase in earnings invested in United States property (as determined in section 956).

The earnings of a CFC classified as subpart F income or as investments in United States property give rise to taxable income to a United States shareholder only for the portion of the earnings represented by the portion of the year in which the foreign corporation was a CFC. Generally, if CFC stock is transferred by any person to a United States shareholder and the transferor receives a distribution during the taxable year, the acquiring shareholder may reduce the amount of subpart F income for the current taxable year which he would otherwise be required to include in gross income, by the amount of such dividend.

A United States shareholder who is a qualified shareholder of an electing foreign investment company (section 1247 as added by section 14 of this Act) or is subject to tax under section 551(b) (relating to foreign personal holding company income) for any taxable year is not required to include under gross income, for such year, any amount of income under this section with respect to the foreign investment company or foreign personal holding company.

A United States shareholder is defined as a citizen, resident alien, or any domestic entity who owns directly or indirectly through attribution rules of section 958(a) or (b) at least 10 percent of the voting stock of a CFC.

952

Subpart F income defined.—Subpart F income means the sum of (1) the income derived from the insurance of United States risks (section 953) and (2) the foreign base company income (section 954). Such income does not include income within the United States and taxed under United States law. The subpart F income for any taxable year is limited to the earnings and profits for such year.

953

Income from insurance of United States risks.—Generally, income derived from insurance (or reinsurance) of United States risks is included as subpart F income if the premiums thereon exceed five percent of the CFC's total premiums for the taxable year and if such income would (subject to certain modifications) be taxed under subchapter L of chapter 1 of the Code if the CFC were a domestic insurance corporation. Certain sections of subchapter L are either modified or inapplicable in determining underwriting income as well as net investment income.

954

Foreign base company income.—The second element comprising subpart F income is foreign base company income. This section defines foreign base company income as the sum of three items each reduced by deductions properly allocable under regulations. These items are:

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1. Foreign personal holding company income as modified in section 954(c),

2. Foreign base company sales income (defined in section 954(d)) which generally involves income derived from the purchase or sale of personal property from or to a related person. This provision does not apply, however, if the property is manufactured, produced, grown, or extracted in the country where the CFC is organized, or if the property purchased outside such country is sold for use or consumption in such country, and

3. Foreign base company service income (defined in section 954(d)) which generally involves compensation derived in connection with technical or similar services performed for a related person outside the country in which the CFC is organized.

Certain types of income are excepted from foreign base company income. They include (1) dividends, interest, and capital gains received from qualified investments in less developed countries, limited, however, to the increase in such investments for the taxable year; (2) income from certain shipping and air transportation; and (3) income received by a CFC where it is established to the satisfaction of the Secretary or his delegate that the CFC is not availed of to reduce taxes. In addition, special rules apply where the foreign base company income is less than 30 percent or more than 70 percent of the CFC's gross income.

955

Withdrawal of previously excluded subpart F income from qualified investment.—This section of the Code provides rules for the inclusion in a United States shareholder's gross income of amounts withdrawn from investments in less developed countries which were at one time excluded from subpart F income. Qualified investments in a less developed country include stock and certain obligations of a less developed country corporation, ten percent of whose voting stock is directly owned by the CFC, and obligations of a less developed country. Property disposed of within 6 months after acquisition does not qualify as such property. This section of the Code also defines a less developed country corporation as a foreign corporation engaged in business and at least 80 percent of whose income and property is generally in less developed countries or foreign shipping or aircraft corporations meeting certain requirements. A less developed country means any foreign country (other than an area within the Sino-Soviet bloc) or a United States possession which is so designated by Executive Order. Certain countries are specifically excluded.

956

Investment of earnings in United States property.—This section of the Code provides rules for determining the United States shareholder's share of CFC's increase in earnings invested in United States property. United States property is defined as certain property located in the United States and acquired after December 31, 1962. Certain exceptions are provided.

957

Controlled foreign corporations; United States person.—This section of the Code is a definitional section. A controlled foreign corporation (CFC) means generally any foreign corporation of which more than 50 percent of its voting stock is owned directly or through attribution by United States shareholders (10 percent owners) on any day during the taxable year of such CFC. A CFC also means certain foreign corporations receiving insurance premiums attributable to United States risks. Certain corporations organized in Puerto Rico, Virgin Islands, or United States possessions meeting certain requirements are not treated as CFC's. This section of the Code also defines United States person as a citizen or United States resident or any domestic entity. However, certain individuals of Puerto Rico, Virgin Islands, or United States possession are excepted.

958

Rules for determining stock ownership.—This section of the Code provides two separate sets of attribution rules. One provides a limited rule of stock ownership for determining the amount taxable to a United States shareholder. In such case, a United States shareholder owns stock in a foreign corporation which he owns proportionally through foreign entities. The other provides rules of constructive ownership based, with certain exceptions and modifications, on section 318. The purpose of the second rule is to determine whether a United States shareholder has the requisite ownership to be liable for tax under section 951(a); to treat a person as a related person for purpose of the foreign base company sales income; and to make a corporation a CFC under section 957.

959

Exclusion from gross income of previously taxed earnings and profits.—This section of the Code provides that earnings and profits of a foreign corporation attributable to amounts once included in gross income under section 951(a) are not again included in gross income when actually distributed. Also, this section prevents including in gross income under section 951(a)(1)(B) any increase in earnings invested in United States property to the extent such increase can be considered as attributable to income taxable under section 951 (a)(1)(A). Further, rules are provided for allocation of distributions to earnings and profits whereby actual dividends are treated first as being paid out of earnings invested in United States property, then out of subpart F income, and finally out of earnings and profits which have not previously been taxed to the United States shareholders.

960

Special rules for foreign tax credit.—This section of the Code provides rules, consistent with section 902 (as amended by section 9 of this Act), for treating foreign taxes paid by CFC's on undistributed earnings which are included in the gross income of domestic corpora-

tions under section 951(a) as deemed paid by such domestic corporations. Rules are also provided to prevent doubling of the foreign tax credit when actual dividends are paid and to increase the section 904 limitation in the year of actual distributions so that a credit will be allowed for foreign taxes imposed on the income distributed after it was included in gross income under section 951. Refunds are allowed if the increase in the section 904 limitation exceeds the United States tax in the year of actual distribution.

961

Adjustment to basis of stock in controlled foreign corporations and of other property.—Section 961 of the Code in general provides rules for the adjustment to basis of a United States shareholder's stock in a CFC by the amount included in gross income under section 951 and by the amount which is excluded from gross income under section 959(a). Special rules are provided in the case of an individual shareholder who has made an election under section 962.

962

Election by individuals to be subject to tax at corporate rates.—This section of the Code provides an election for an individual United States shareholder to be taxed at corporate rates on the undistributed earnings included in his gross income under section 951(a). Such shareholder is entitled to the foreign tax credit under section 960 similar to a corporation. An allocation rule is provided for the surtax exemption and special rules apply in the taxable year actual distributions are made.

963

Receipt of minimum distributions by domestic corporations.—Section 963 of the Code provides that no amount is to be included in gross income under section 951(a)(1)(A)(i) for the taxable year with respect to the subpart F income of a CFC if a United States shareholder which is a domestic corporation consents to all the regulations prescribed under section 963 prior to the last day prescribed by law for filing its return and if such shareholder receives its share of the minimum distribution of the earnings and profits for the taxable year of such CFC. A schedule of minimum distribution is provided. This schedule indicates the required minimum distribution of earnings and profits, as a percentage, for each category of effective foreign tax rate. In general, the effective foreign tax rate is the percentage that foreign taxes paid or accrued by a CFC with respect to its earnings and profits for the taxable year ending in or with the taxable year of the domestic corporate shareholder bears to the sum of such earnings and profits and such foreign taxes.

In general, this section may apply to a CFC in which a domestic corporate shareholder owns stock directly; to a chain of CFCs in which such shareholder owns stock under section 958(a)(2) to the extent the shareholder so elects; and to all CFCs in which such shareholder owns stock under section 958(a)(2), except, upon election by the shareholder, certain less developed country corporations. For purposes of the last category, certain foreign branches of a domestic

corporate shareholder may be elected to be included. An affiliated group of domestic corporations which makes a consolidated return under section 1501 may elect to be treated as a single United States shareholder.

964

Miscellaneous provisions.—In general, this section of the Code provides that for purposes of subpart F, earnings and profits of any foreign corporation is to be determined under rules substantially similar to those applicable to domestic corporations. Earnings and profits of a CFC for any taxable year are not to be included in earnings and profits for purposes of section 952 (relating to subpart F income defined), section 955 (relating to withdrawal of previously excluded subpart F income from qualified investments), and section 956 (relating to investment of earnings in United States property) if such earnings could not be distributed to United States shareholders because of currency or other restrictions of any foreign country.

970

Reduction of subpart F income of export trade corporations.—Section 970 of the Code provides in general, that the subpart F income of a CFC which for the taxable year is an export trade corporation (ETC) is reduced by the export trade income of such corporation for such year to the extent it constitutes foreign base company income (as defined in section 954). However, the reduction in subpart F income is limited to the lesser of:

1. One and one-half times the export promotion expenses (as defined in section 971(d)) for the taxable year, or
2. Ten percent of the gross receipts for the taxable year from the sale, installation, operation, maintenance, or use of property from which the ETC derived export trade income.

The reduction under (1) or (2) above may not exceed an amount which bears the same ratio to the increase in investments in export trade assets of an ETC as the export trade income which constitutes foreign base company income bears to the entire export trade income for the taxable year. Generally a decrease in the investments in export trade assets results in an inclusion of income in the U.S. shareholder's gross income under section 951(a)(1)(A)(ii).

971

Definitions.—This section of the Code is a definitional section. In general, a CFC is an export trade corporation (ETC) if for three years preceding the taxable year it derived at least 90 percent of its gross income from sources without the United States and at least 75 percent of its gross income constituted export trade income.

In very general terms, export trade income means net income from the sale to an unrelated person for use outside the United States of export property; commissions, etc. from services performed in connection with the use by an unrelated person outside the United States of patents, etc. owned by the United States manufacturer of export property, but only if the CFC derived export trade income from the sale of such property; commissions, etc. from the use of export property by an unrelated person or from the use of export property in the

rendition of technical, etc. services to an unrelated person; and interest from export trade assets.

170, 301, 312, 341, 453, 751, 1245

Gain from dispositions of certain depreciable property.—Under prior law, the excess of gains over losses from the sale or exchange of most depreciable property used in a trade or business was treated as capital gain under section 1231. Under new section 1245, gain upon the sale, exchange, or other disposition of certain depreciable property will be ordinary income to the extent that the basis of the property in the hands of the taxpayer has been reduced by deductions for depreciation (or amortization under section 168) for periods after December 31, 1961. Any gain in excess of ordinary income recognized under section 1245 will continue to be treated as gain to which section 1231 applies. New section 1245 also provides for recognition of ordinary income in certain cases where gain was not recognized under prior law. Property to which the section applies is called "section 1245 property." Such property is depreciable property (other than livestock) which is personal property, or which is tangible real property (other than a building) if used as an integral part of manufacturing, production, extraction, or in certain public service activities, or is a research or storage facility used in connection with one of the enumerated activities. Subsection (b) of new section 1245 provides certain exceptions to the general rule. Under subsection (b) no ordinary income will result by reason of a transfer at death, or a disposition by gift. Section 170 is amended, however, to provide that if section 1245 property is given to a charitable organization, the deduction for charitable contributions is to be reduced by the amount of ordinary income that would have been recognized under section 1245 if the property had been sold at its fair market value. Under subsection (b), ordinary income will result upon certain tax-free transfers (contributions of property to a corporation or partnership, certain corporation liquidations, etc.), like-kind exchanges, and involuntary conversions of depreciable property, only to the extent that gain is recognized without regard to section 1245. A special rule governs the application of new section 1245 to partnership distributions, etc. New section 1245 applies only to dispositions during a taxable year beginning after December 31, 1962.

167

Section 167, relating to depreciation, is amended to permit taxpayers to elect to change from a declining balance or sum of the years-digits method to the straight line method of depreciating property subject to section 1245. The election (to be made in a manner prescribed by regulations) may be made on or before the due date for filing the income tax return for the first taxable year beginning after December 31, 1962. Section 167 is also amended to allow a reduction of salvage value required to be taken into account for purposes of computing depreciation. The salvage value of depreciable personal property (other than livestock) with a useful life of 3 years or more may be reduced by an amount equal to 10 percent of the basis of the property. The salvage value amendment applies only to taxable years

beginning after December 31, 1961, and to property acquired after October 16, 1962.

613

Section 613(a), relating to percentage depletion, is amended to provide that, for purposes of computing the limitation on allowable percentage depletion to 50 percent of taxable income from the property, expenses of mining will be reduced by any ordinary income under section 1245 which is properly attributable to the property. The amendment to section 613(a) is applicable to taxable years beginning after December 31, 1962.

1246

Gain on foreign investment company stock.—Section 14 of this Act adds new sections 1246 and 1247 to the Code. Generally, section 1246 treats the gain on a sale or exchange after December 31, 1962, of stock in a foreign corporation which was a foreign investment company at any time during the period which the taxpayer held such stock as gain from the sale or exchange of property which is not a capital asset. This provision also applies to certain redemptions and distributions under sections 302 and 331. Such ordinary income treatment applies only to the extent of the taxpayer's ratable share of earnings and profits of the foreign investment company for taxable years beginning after December 31, 1962, and during the period that the taxpayer held such stock. This section does not apply to short-term capital gains.

The burden is on the taxpayer to establish the amount of the accumulated earnings and profits of the foreign investment company and his share of such earnings and profits for the period during which the taxpayer held such stock. Failure to establish this information will result in treating all the gain from the sale or exchange of stock in such company as ordinary income.

A foreign investment company for purposes of section 1246 means a foreign corporation (1) which is registered under the Investment Company Act of 1940 either as a management company or as a unit investment trust, or (2) which is not so registered, is engaged in the investment business, and more than 50 percent of the voting power or value of the stock is held directly or indirectly by United States persons (as defined in section 7701(a)(30)). The second category does not apply to brokers, banks, and small loan companies.

Rules relating to stock having transferred or substituted basis apply and the holding period for such stock is determined under section 1223. Special rules are provided for stock acquired from a decedent and stock of a foreign investment company held through a domestic corporation or through a domestic trust to which section 677 (relating to income for benefit of grantor) applies. Every United States person owning 5 percent in value of stock of a foreign investment company must furnish with respect to such foreign corporation such information as the Secretary or his delegate prescribes by regulations.

1247

Election by foreign investment companies to distribute income currently.—This section of the Code provides that if a registered foreign investment company (described in section 1246(b)(1)) elects on or

before December 31, 1962, with respect to each taxable year beginning after December 31, 1962, to (1) distribute at least 90 percent of its taxable income currently (computed as though it were a domestic corporation) with certain modifications, (2) inform its shareholders in writing their proportionate amount of long-term gains, whether or not distributed, and (3) provide information required under regulations then section 1246 will not apply to those shareholders (designated qualified shareholders) who include in their income their pro rata share of long-term capital gains, whether or not distributed. The election terminates with the failure to comply with the terms of the election unless there is reasonable cause, or when the company becomes a foreign personal holding company, or when the company ceases to be a foreign investment company. The company can elect within two and one-half months after the end of the taxable year to consider distributions made within that period as distributed during such taxable year.

An electing foreign investment company may under certain conditions elect to pass through its foreign income taxes to its shareholders. Under such election, the foreign taxes will not be allowed as a deduction to the foreign investment company and each qualified shareholder must include his share of such foreign taxes in income but he will be entitled to a foreign tax credit. The shareholder's share of the foreign taxes must be designated by the company in a written notice to the shareholder within 45 days after the end of the company's taxable year.

Provisions are made for adjustments to earnings and profits and the shareholder's basis to reflect the inclusion of the undistributed capital gains in the shareholder's income. Any loss from the sale of stock held six months or less will be treated as a long-term capital loss to the extent that the basis of such stock was increased by reported and undistributed long-term capital gains.

312

Allocation within affiliated group.—Section 14(b)(1) of this Act amends section 312 by adding a new subsection (l). Paragraphs (1) and (2) of subsection (l) provide that earnings and profits of an affiliated group in which the foreign investment company is a member, are to be allocated. Paragraph (3) of subsection (l) provides rules governing the reduction of earnings and profits of a foreign investment company as a result of amounts it distributes after December 31, 1962, in a partial liquidation or in a redemption to which section 302(a) or 303 applies.

751(d)(2) (C) and (D)

Sale or exchange of interest in partnership.—Section 14(b)(2) of this Act amends section 751(d)(2) by striking subparagraph (C) and adding new subparagraphs (C) and (D) which treat as an inventory item for purposes of subchapter K of the Code certain stock of a foreign investment company.

1223(10)

Holding period of property.—Section 14(b)(3) of this Act amends section 1223 by redesignating paragraph (10) as paragraph (11) and

adding a new paragraph (10) which includes the period foreign investment company stock is held by a trust or by a corporation covered by section 1246(d).

Effective date. The amendments made by section 14 of the Act apply to taxable years beginning after December 31, 1962.

1248

Gain from certain sales or exchanges of stock in certain foreign corporations.—Section 15(a) adds section 1248 to apply with respect to sales or exchanges of stock in a foreign corporation occurring after December 31, 1962. Generally, section 1248(a) provides that gain recognized on the sale or exchange of stock by a U.S. person owning 10 percent or more of the voting stock of a foreign corporation shall be included in gross income of such person as a dividend to the extent of the earnings and profits of the foreign corporation attributable to the period the stock sold or exchanged was held by such person while the foreign corporation was a controlled foreign corporation. In determining stock ownership the attribution rules of new section 958 are applicable. Section 1248(b) provides a limitation on the amount of tax payable by a U.S. person who is an individual in the case of a sale of a capital asset held in excess of 6 months, and subsections (c) and (d) provide rules for determining earnings and profits for purposes of this section. Generally, earnings and profits of the foreign corporation include earnings and profits of its subsidiaries for the periods the subsidiaries were controlled foreign corporations, but exclude (1) earnings and profits attributable to income taxed under section 951, (2) earnings and profits attributable to gain from the sale or exchange of property in pursuance of a plan of complete liquidation, (3) earnings and profits accumulated by a foreign corporation while it was a less developed country corporation, (4) income from U.S. sources while engaged in business there, and (5) earnings and profits of the foreign corporation which was a foreign investment company for taxable years in which the U.S. shareholder whose stock is sold or exchanged was a qualified shareholder as defined in section 1247. Subsection (e) provides rules relating to the sale or exchange of stock of certain domestic corporations. Subsection (f) provides certain exceptions to this section. These are generally any amount treated under the 1954 Code as a dividend, gain from the sale of noncapital assets, and short-term capital gains; distributions to which section 303 applies; and gain realized on section 356 exchange. Subsection (g) places the burden on the taxpayer to establish the amount of earnings and profits. Failure to establish this amount will result in treating all of the gain as a dividend under subsection (a). Also, unless the taxpayer establishes the amount of foreign taxes required under subsection (b) of this section the limitation provided in subsection (b) is not to apply.

1249

Gain from certain sales or exchanges of patents, etc., to certain foreign corporations.—Section 16 of this Act amends part IV of subchapter P of chapter 1 of the Code by adding section 1249 which provides that gain from the sale or exchange after December 31, 1962, of a pat-

ent, invention, model, or design (whether or not patented), copyright, secret formula or process, or other similar property right by a United States person (as defined in new section 7701(a)(30)) to a foreign corporation which such person controls is considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231. For this rule to apply, such gain must (but for this section) be gain from the sale or exchange of a capital asset or of property described in section 1231. For purposes of this section, a United States person controls a foreign corporation if he owns directly or indirectly, using the constructive ownership rules of new section 958, more than 50 percent of the voting stock of such corporation. This section applies to taxable years beginning after December 31, 1962.

1381(a), 1381(b), 1382(a), 1382(b), 1382(c), 1382(d), 1382(e), 1382(f), 1383(a), 1383(b), 1385(a), 1385(b), 1385(c), 1388(a), 1388(b), 1388(c), 1388(d), 1388(e), 521(a), 522, 6072(d)

Tax treatment of cooperatives and patrons.—Section 17(a) of this Act adds a new subchapter T consisting of parts I, II, and III (relating to cooperatives and their patrons) to chapter 1 of the Code, so as to impose, upon either the cooperatives or on their patrons, a single tax on the income of the cooperatives.

Part I (consisting of sections 1381, 1382, and 1383 (relates to the tax treatment of cooperatives. Section 1381(a) specifies those organizations to which such part applies; that is, so-called tax-exempt farmers' cooperatives (section 521), other farm and consumer cooperatives, and any corporation operating on a cooperative basis. Such part I does not apply to mutual savings banks, building and loan associations, mutual insurance companies, mutual ditch, irrigation or REA cooperatives, or to organizations which furnish electric energy or provide telephone service to persons in rural areas. Section 1381(b) continues the rule that so-called tax-exempt farmers' cooperatives (section 521) are subject to the taxes imposed by section 11 or 1201.

Section 1382 (relating to taxable income of cooperatives) provides in subsection (a) that "gross income" is to be determined without any adjustment by reason of any allocation or distribution to a patron out of the net earnings of the organization; any amount which is "not taken into account" in computing taxable income under subsection (b) is to be treated in the same manner as if it were an item of gross income and a deduction therefrom. Subsection (b) provides that, in computing "taxable income" of the cooperative, there is not to be taken into account patronage dividends paid with respect to patronage occurring during the taxable year or amounts paid in redemption of nonqualified written notices of allocation (paid during the "payment period" for the taxable year). In addition, deductions are allowed for amounts paid as dividends on capital stock of so-called tax-exempt farmers' cooperatives and, to such organizations only, amounts paid on a patronage basis on earnings derived from business done with the United States or its agencies or from sources other than patronage as well as amounts paid in redemption of certain nonqualified written notices of allocation. Under subsection (d), "payment period" for any taxable

year is the period beginning with the first day of such taxable year and ending with the fifteenth day of the ninth month after the close of such year. A "qualified check" issued during such payment period will be treated as an amount paid in money if it is endorsed and cashed on or before the ninetieth day after the close of such period. Subsection (e) provides that, in the case of pooling arrangements for the marketing of products, the patronage shall be treated as occurring during the year the pool closes (under regulations prescribed by the Secretary or his delegate). Under subsection (f), earnings received after patronage occurs will be considered to have been received with respect to patronage in the year in which such earnings are includible in gross income.

Section 1383 (relating to computation of tax where the cooperative redeems nonqualified written notices of allocation) provides in subsection (a) that if a deduction is allowable for amounts paid in redemption of nonqualified written notices of allocation, the tax imposed shall be the lesser of (1) the tax for the taxable year computed with such deduction, or (2) an amount equal to the tax for the taxable year computed without such deduction minus the decrease in tax for any prior year which would result solely from treating such nonqualified written notices as qualified written notices. If the decrease in tax so ascertained exceeds the tax for the taxable year computed without the deduction, such excess is to be credited or refunded as provided in subsection (b).

Part II (consisting of section 1385) relates to the tax treatment of patrons of patronage dividends. Section 1385 (relating to amounts includible in patrons' gross income) provides in subsection (a) that each person shall include in gross income the amount of any patronage dividend as well as any amount which he receives with respect to earnings from business done with the United States, etc., during the taxable year. Subsection (b) excludes from gross income any amount which is taken into account as an adjustment to basis of property or is attributable to personal living or family items. Under subsection (c), the basis of nonqualified written notices of allocation in the hands of the patron is zero; if acquired from a decedent its basis is the basis in the hands of the decedent. A gain on the redemption, sale, or other disposition of such notices of allocations are to be considered as a gain from the sale or exchange of property which is not a capital asset.

Part III (consisting of section 1388) provides definitions and special rules for purposes of the new subchapter T. Subsection (a) of section 1388 defines "patronage dividend" as an amount paid to a patron on the basis of quantity or value of business done with or for such patron, under an obligation (existing before the amount was received by the cooperative) to pay such amount, and which is determined with reference to the net earnings of the organization. The term does not include any amount paid out of earnings from business other than with or for patrons, or any amount which is out of earnings from business done with or for other patrons to whom no amounts (or smaller amounts) are paid. Subsection (b) defines "written notice of allocation" as capital stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice, which discloses the stated dollar amount allocated and the

amount which is a patronage dividend. Subsection (c) defines "qualified written notice of allocation" as a written notice which may be redeemed in cash within 90 days after it is issued, and a written notice which the distributee has consented to take into account at its stated dollar amount. However, such term does not include any written notice of allocation unless at least 20 percent of the amount of the patronage dividend, or other payment, is paid in money or by qualified check. The consent required of the patron may be given in writing by the patron, by obtaining or retaining membership in the cooperative under bylaws providing that membership constitutes consent (a copy of such bylaws must be furnished to the member), or by endorsing and cashing a qualified check. Written consent will be effective for all subsequent years but may be revoked before the end of the year in which the patronage occurs. The so-called bylaw consent cannot be revoked. A "qualified check" includes only a check or other instrument issued to a patron who has not otherwise consented with respect to the distribution of which the check or other instrument is a part and on which is clearly imprinted a statement that the endorsement and cashing of the check constitutes consent of the payee to include in gross income the stated dollar amount of the patronage dividend. Subsection (d) defines "nonqualified written notice of allocation" as any written notice of allocation which is not a qualified written notice of allocation or a qualified check which is not cashed on or before a specific day.

Under subsection (e), property (other than a written notice of allocation) is to be taken into account at its fair market value, and a qualified written notice of allocation is to be taken into account at its stated dollar amount.

Section 17(b) of this Act makes technical amendments to sections 521(a) and 6072(d) and repeals section 522, so as to conform, and give proper effect to, the new subchapter T. Section 521(a) is amended merely to substitute "part I of subchapter T (section 1381 and following)" for "section 522". Section 522 is repealed as no longer necessary for taxable years to which subchapter T applies since all the rules provided in section 522 are reflected in such new subchapter T. Section 6072(d) is amended to permit the filing of returns within eight and one-half months after the close of the taxable year by, not only the so-called tax-exempt farmers' cooperatives, but also any cooperative which is under an obligation to pay (or has paid) at least 50 percent of its net earnings as patronage dividends, as provided in paragraph (2) of such section 6072(d).

Section 17(c) of this Act sets forth the effective dates applicable to the amendments made by subsections (a) and (b). For the cooperative, such amendments apply to taxable years beginning after December 31, 1962; for the patrons, section 1385 applies to amount paid by cooperatives in taxable years beginning after December 31, 1962. With respect to amounts paid or allocated by cooperatives before the first day of the first taxable year beginning after December 31, 1962, or on or after such first day with respect to patronage occurring before such first day, the tax treatment shall be made without regard to the new subchapter T.

2031(a), 2033, 2034, 2035(a), 2036(a), 2037(a), 2038(a), 2040, 2041(a)

Inclusion of foreign real property in gross estate.—Section 18 of this Act amends sections 2031(a), 2033, 2034, 2035(a), 2036(a), 2037(a), 2038(a), 2040, and 2041(a) of the Code to eliminate the exclusion from the gross estate of real property situated outside the United States. The amendment results in the inclusion in the gross estate of decedents who are citizens or residents of the United States of the fair market value of their interests in foreign real property. The amendment is effective with respect to estates of decedents who die after October 16, 1962, but permits the continued exclusion of the value of certain foreign real property in estates of decedents who die after October 16, 1962, and before July 1, 1964. In this latter situation the exclusion applies to foreign real property (1) acquired by the decedent prior to February 1, 1962, or (2) acquired by the decedent after January 31, 1962, by gift or from a prior decedent by devise or inheritance, or by reason of death, form of ownership or other conditions (including the exercise or non-exercise of a power of appointment), but only if the donor or prior decedent had acquired the property or interest which passed from him to the decedent or had possessed a power to appoint such property or interest to the decedent before February 1, 1962.

6041, 6042, 6044, 6049, 6652, 6678

Changes in provisions governing reporting of payments of dividends, patronage dividends, and interest.—Section 19 of the Act changes the requirements of the Code for the reporting of payments of dividends, patronage dividends, and interest by amending sections 6041, 6042, and 6044 and by adding a new section 6049. In general, the new provisions require that persons making payments of dividends, patronage dividends (and certain other distributions by cooperatives), or interest aggregating $10 or more to any person during the calendar year shall file annual returns reporting such payments. Persons who receive payments of dividends or interest as nominees for other persons and who make payments to such other persons aggregating $10 or more per person during a calendar year in respect of the dividends or interest so received also are required to make returns with respect to annual payments of $10 or more per person. In addition to the returns required to be filed with the Government, annual statements are required to be furnished by the payers (including nominees) to all recipients of dividend, patronage dividend, or interest payments of $10 or more a year, showing the amount of the payments reported to the Government and the name and address of the payer. Civil penalities for failure of compliance with the requirements for furnishing returns to the Government and statements to payees with respect to payments of $10 or more are provided in an amendment of section 6652 and in a new section 6678. The penalty with respect to returns to the Government and statements to payees is $10 for each failure with a maximum of $25,000 for all failures during any calendar year. The new provisions apply to payments of interest or dividends made on or after January 1, 1963, and to payments by cooperatives made on or after January 1, 1963, with respect

to patronage occurring on or after the first day of the first taxable year of the cooperative beginning on or after January 1, 1963.

318, 6038

Information with respect to certain foreign corporations.—Section 20(a) of the Act amends section 6038 to provide that information returns, previously required only from domestic corporations, be submitted by all United States persons in control of foreign corporations. In addition to the items of information with regard to those corporations specified in the statute, the new law gives the Secretary or his delegate authority to require the submission of other similar or related information. Prior law required the supplying of information only with respect to a foreign subsidiary or a subsidiary of that subsidiary. Information is now required with respect to all foreign corporations controlled, regardless of the number of tiers involved. The definition of control has been broadened to include most of the constructive ownership rules of section 318 and certain modifications and limitations have been imposed on the penalty provisions provided for failure to comply. All amendments apply only with respect to annual information returns required for accounting periods of foreign corporations beginning after December 31, 1962. Information may be required under this section only with respect to annual accounting periods for which regulations under this section are in effect from the first day of such period. Section 318 is amended by section 20(d) of the Act by adding a cross-reference to section 6038.

6046, 6679

Returns as to organization or reorganization of foreign corporations and as to acquisitions of their stock.—Section 20 of the Act amends section 6046 of the Code to require that information returns be made by (1) each United States citizen or resident who is on January 1, 1963, or who at any time thereafter becomes, an officer or director of a foreign corporation, 5 percent or more in value of the stock of which is owned by a United States person, (2) each United States person who owns on January 1, 1963, 5 percent or more in value of the stock of a foreign corporation, or who at any time thereafter acquires stock which added to any stock owned on January 1, 1963, equals 5 percent or more in value of the stock of a foreign corporation, or who at any time thereafter acquires an additional 5 percent or more in value of the stock of a foreign corporation, and (3) each person who after January 1, 1963, becomes a United States person while owning 5 percent or more in value of the stock of a foreign corporation. The term "United States person", as defined in section 7701(a)(30), is so used in this section.

The Secretary or his delegate is authorized to prescribe by forms or regulations that the returns required under this section set forth such information regarding the foreign corporation as is necessary for carrying out the provisions of the income tax laws. However, the information which the Secretary or his delegate may require from the officers or directors, as such, of a foreign corporation is limited to the names and addresses of the United States persons described in paragraph (2) of subsection (a).

Under this section persons are required to take into account stock which they own directly or indirectly. Stock owned by an individual's brothers or sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants is considered owned by such individual.

The time for filing a return under this section is on or before the 90th day after the day on which the liability to file such return arises.

Under a limitation in this section where a liability to file a return arises on or after January 1, 1963, and before June 1, 1963—

(1) unless regulations under this section are in effect on or before March 1, 1963, no information shall be required to be furnished, and

(2) If regulations become effective on a day after such liability arises, the date for filing the return under this section shall be on or before the 90th day after the effective date of the regulations.

Also, with respect to liabilities arising on or after June 1, 1963, no information shall be required to be furnished, unless regulations under this section have been in effect for at least 90 days before the date on which such liability arises.

This Act also adds a new section 6679 to the Code. Such section imposes a civil penalty of $1,000 on any person required to file a return under section 6046 who fails to do so at the time provided in such section, or who files a return but fails to show the information required, unless it is shown that either failure is due to reasonable cause.

It is also provided in section 6679 that the deficiency procedures, provided for in subchapter B of chapter 63 of the Code, shall not apply in the assessment or collection of this penalty.

182, 263(a)(1)

Deduction by farmers of expenditures incurred in the clearing of land.—Section 21 of the Act adds a new section 182 which permits taxpayers engaged in the business of farming to make an annual election for taxable years beginning after December 31, 1962, to deduct expenditures not otherwise allowable (including depreciation charges) incurred to eradicate trees and stumps or to accomplish similar objectives for the purpose of making land suitable for use by the taxpayer for the production of crops or for other agricultural purposes. The deduction for any taxable year is limited to the lesser of $5,000, or 25 percent of the taxpayer's gross income from farming reduced by the business expenses allocable thereto. Expenditures incurred in excess of the applicable limitation for a taxable year must, as in the past, be capitalized. This section of the Act also amends section 263(a)(1) to insure that expenditures covered by section 182 will be removed from the operation of the general rule applicable to capital expenditures.

1307(e)

Election with respect to charitable contributions.—Section 22 of the Act adds to the Code a special rule for determining the amount of charitable contributions deductible by an individual when his "bunched income" is to be spread under the special "averaging" provisions of the tax law. Under this rule the limitation on charitable contribu-

tions made in the year in which the bunched income is received may be applied before the income is spread over the years to which it is attributable. Only the net amount of bunched income remaining after the charitable contribution has been deducted will in effect be spreadback over the year to which attributable.

This provision is to apply with respect to amounts received or accrued in taxable years beginning after December 31, 1961.

Retroactive application of section 1371(c), relating to stock owned by husband and wife in an electing small business corporation under subchapter S.—Section 23 of this Act provides that section 1371(c) (relating to the determination of the number of shareholders of a small business corporation where stock is owned by a husband and wife) is, subject to the provisions for filing of election and consents, to apply to taxable years beginning after December 31, 1957, and before January 1, 1960. Prior to such amendment, section 1371(c) applied only to taxable years beginning after December 31, 1959. Section 23 of this Act provides a 1-year period within which an otherwise qualifying small business corporation may make a special election to have the earlier effective date of section 1371(c) apply. For the special election to be valid, a corporation must have previously made a valid election to have its income taxed directly to its shareholders, and each person who is a shareholder at the time of the special election (as well as each person who was a shareholder for any taxable year beginning after December 31, 1957, and ending before the date on which the special election is made) must give his consent. In addition, where a special election (and the requisite consents) has been made, the statute of limitations for assessing additional tax against the corporation or the shareholders attributable to the earlier effecive date of section 1371(c), and the statute of limitations for allowing a credit or refund of any overpayment of tax by the corporation or its shareholders attributable to the earlier effective date of section 1371(c), is to remain open, or be opened, for 1 year following the date of the election.

Certain losses sustained in converting from street railway to bus operations.—Section 24 of this Act provides an additional 5-year carryover period, beginning with 1960, for net operating losses incurred in the calendar years 1953 and 1954 principally as the result of conversion from street railway to bus operations. This section applies only to a corporation for years in which (i) it is engaged in the furnishing or sale of transportation and (ii) its rates for the transportation are established or approved by a regulatory body.

Retroactive tax exemption for International Hod Carriers' Building and Common Laborers' Local 435 pension fund.—Section 25 of this Act provides that the union-negotiated pension plan of Local Union No. 435 of the International Hod Carriers' Building and Common Laborers' Union of America is to be treated as a qualified, tax-exempt trust for the period beginning May 1, 1960, and ending April 20, 1961, if it is shown to the satisfaction of the Secretary of the Treasury that the trust was not operated during this period in a manner which would jeopardize the interests of its beneficiaries. This will permit employers to deduct contributions made to this trust in this period.

Exclusion of awards on Japanese-American evacuation claims.—Section 27 of this Act provides an exclusion for awards received by Americans of Japanese ancestry pursuant to the act allowing claims for damages they suffered as a result of being evacuated under military orders from the West coast during World War II.

The exclusion applies to taxable years ending after July 2, 1948, which is the date of enactment of the Japanese-American Evacuation Claims Act. This section provides for the allowance of refund or credit of overpayments resulting from its enactment in cases which have become barred, if claim is filed within one year after date of enactment. In these cases the amount of the refund will not be diminished by any credit or set-off based upon any item other than the award. No interest is allowed on the refund.

216

Deduction for business depreciation by cooperative tenant-stockholder.—Section 28 of this Act adds a new subsection (c) to section 216 of the Code. Prior to this amendment, under section 216, a tenant-stockholder in a cooperative housing corporation was allowed a deduction for his share of the taxes and interest paid by the corporation but was not permitted any deduction for amortization or depreciation where the premises were used in a trade or business or for the production of income. This result was due to the fact that what he owned was merely stock in a corporation; he had no depreciable interest in the real estate and could not amortize his right of tenancy as it is an integral part of the stock for which no separable basis could be ascribed.

This amendment, which is applicable to taxable years beginning after December 31, 1961, allows a depreciation deduction under section 167(a) on so much of the basis of the stock as is allocable, under regulations prescribed by the Secretary or his delegate, to the right of tenancy used by the taxpayer in his trade or business or for the production of income.

Deduction for contributions to certain judicial reform organizations.—Section 29 of this Act allows a charitable deduction under section 170 for amounts contributed to any nonprofit organization created and operated exclusively to consider proposals for the reorganization of the judicial branch of any State or local government and to provide information, make recommendations and seek public support or opposition to these proposals. The organization may not, however, participate in any political campaign on behalf of any candidate for public office.

The charitable deduction is allowed for contributions or gifts made after December 31, 1961, with respect to a referendum occurring during 1962.

Retroactive application of section 1374(b), relating to the allowance of deduction of net operating loss of a subchapter S corporation.—Prior to enactment of section 30 of this Act, a shareholder in an electing small business corporation was allowed a deduction in his final taxable year for his pro rata share of the net operating loss of the corporation for the year of the corporation ending after his death only if he died after September 23, 1959. Section 30 of this Act al-

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lows a deduction in the final taxable year of a deceased shareholder of his pro rata share of the net operating loss of the corporation for the year of the corporation ending after his death if he died after September 2, 1958.

Treaties.—Section 31 of the Act provides that section 7852(d) of the Code (relating to treaty obligations) shall not apply to any amendment made by the Revenue Act of 1962. Section 7852(d) provides that no provision of the 1954 Code shall apply where it conflicts with any treaty obligation of the United States in effect on August 16, 1954, the date on which the 1954 Code was enacted.

PUBLIC LAW 87–858 (page 206).

4216(b)(2)(C)

Expanded use of special constructive sale price for purposes of manufacturers' excise taxes.—Section 4216(b)(2) of the Code provides, subject to certain limitations, for a special constructive sales price for the purpose of computing excise tax liability in the case of sales of taxable articles by the manufacturer thereof at retail, to retailers, or to special dealers. One of the limitations is contained in subparagraph (C) of this section of the Code, namely, that the normal method of sales for the articles within the industry is not to sell such articles at retail or to retailers or both. Section 1 of this Act amends subparagraph (C) so that this limitation as to the normal method of sales within the industry, applies only in respect of sales of automobiles, trucks and buses, business machines, and matches. The amendment applies with respect to articles sold by the manufacturer, producer, importer on or after October 1, 1962.

170(b)(1)

Limitation of charitable deductions.—Section 2 of this Act amends section 170(b) of the Code to expand the list of organizations to which deductible contributions may be made in excess of the general 20 percent limitation. Section 170(b)(1)(B) limits the amount of an individual's charitable contribution deductions to 20 percent of his adjusted gross income. Section 170(b)(1)(A) provides for an additional deduction (not to exceed 10 percent of adjusted gross income) for contributions made to churches, educational organizations and hospitals. This amendment adds to the list of organizations qualifying for the additional 10 percent deduction an organization which qualifies under section 503(b)(3) of the Code which is organized and operated exclusively to receive, hold, invest, and administer property and to make expenditures to or for the benefit of a college or university which is an agency or instrumentality of a State or political subdivision thereof, or is owned or operated by a State or political subdivision thereof, or is owned or operated by an agency or instrumentality of one or more States or political subdivisions. An example of an organization that could fit this description is an endowment foundation established by an alumni association to benefit a State University.

A conforming amendment to section 170(b)(1)(B) is also made. This amendment is effective for taxable years beginning after December 31, 1960.

801(g).

Life insurance company contracts with reserves based on segregated asset accounts.—Section 3(a) of this Act amends section 801(g) (relating to variable annuities) to continue the present treatment of variable annuities for the future, without a termination date, and to provide that income allocated to segregated asset accounts (including capital gains income in the case of qualified pension contracts) is not to be taxed to the life insurance company. This amendment is applicable to taxable years beginning after December 31, 1961.

802(a)(2)

Tax in case of capital gains of life insurance companies.—Section 3(b) of this Act amends section 802(a)(2) to provide that if the net long-term capital gain exceeds the net short-term capital loss, a life insurance company is to determine its tax as the lesser of the taxes computed under two methods—a regular method and an alternative method. The regular method requires that the excess be included, in effect, in life insurance company taxable income. The alternative method requires that the tax be determined by adding 25 percent of such excess to the partial tax computed on the life insurance company taxable income determined without the inclusion of such excess. This amendment is applicable to taxable years beginning after December 31, 1961.

809(f)(2)

Limitation on certain deductions of life insurance companies.—Section 3(c) of this Act amends section 809(f)(2) (relating to the application of limitation on certain deductions) to apply the limitation provided by section 809(f)(1) in a new order of priority. This amendment provides that the limitation shall apply first to the deduction allowed under section 809(d)(3) (policyholder dividends), then to the deduction allowed under section 809(d)(6) (the deduction for group insurance premiums), and finally to the deduction allowed under section 809(d)(5) (the deduction for nonparticipating insurance contracts). This amendment is applicable to taxable years beginning after December 31, 1961.

812(e)(2)(B)

New companies qualifying for 8-year loss carryover.—Section 3(d) of this Act amends section 812(e)(2)(B) (relating to a nonqualified corporatioin) to provide that a new life insurance company will not be disqualified from the 8-year operations loss carryover if such new company is connected through stock ownership only with a corporation taxable as an insurance company other than as a life insurance company. This amendment applies to all losses to which the Life Insurance Company Income Tax Act of 1959 would have applied, if it had originally contained this provision, except that a loss arising in 1955 shall not by reason of this amendment be an operations loss carryover to 1961 and there shall be no reduction in the amount of such loss which may be carried to 1962 or 1963 by reason of an offset for 1961.

815(a)

Certain distributions of stock of subsidiaries.—Section 3(e) of this Act amends section 815(a) (relating to the distributions made to shareholders of a stock life insurance company) to provide that after December 31, 1961, and before January 1, 1964, section 815(a) will not apply to a distribution of stock of a controlled corporation, if (1) the distribution meets the requirements of a tax-free distribution under section 355 (2) the controlled corporation is an insurance company subject to tax under section 831 (relating to tax on certain insurance companies other than life and certain mutuals), and (3) control was acquired before January 1, 1963, in a stock-for-stock transaction qualifying as a reorganization under section 368(a)(1)(B).

PUBLIC LAW 87–863 (page 210).

213(c), 213(g)

Medical expense deductions.—Section 1 of this Act amends sections 213(c) and 213(g) to increase the maximum allowable medical expense deductions for individuals. Formerly, section 213(c) provided that the medical expense deduction of those who were both under 65 and not disabled could not exceed $2,500 multiplied by the number of exemptions (excluding those for age and blindness) they were allowed for the taxable year under section 151. In addition section 213(c)(1) limited the deduction for medical expense of an individual making a separate return to $5,000, and those making joint, head of household, or surviving spouse returns to $10,000. This amendment increases the per exemption limitation from $2,500 to $5,000. It also increases the separate return limitation from $5,000 to $10,000, and the joint, head of household and surviving spouse return limitations from $10.000 to $20.000.

Section 213(g) formerly limited the maximum medical expense deduction of an individual to $15,000, if he had attained the age of 65 and was disabled or if his spouse had attained the age of 65, was disabled, and did not file a separate return. Section 213(g) also formerly limited the maximum medical expense deduction of a taxpayer and his spouse to $30,000 if both were over 65 and disabled, provided that they made a joint return. This amendment Act increases these limitations to $20.000 and $40,000 respectively.

These amendments are effective for taxable years beginning after December 31, 1961.

401(h), 404(a)

Qualification of pension plans which provide certain medical and other benefits to retired employees.—Prior to this Act, the inclusion of medical benefits in a pension plan precluded qualification of the plan under section 401 of the Code. Section 2 of this Act amends section 401 to permit qualification of pension or annuity plans which provide for the payment of sickness, accident, hospitalization, and medical expenses of retired employees, their spouses and their dependents. However, the plan will qualify only if the medical benefits are subordinate to the retirement benefits, are funded in a separate account, the contributions are reasonable and ascertainable, the funds can be

used for no other purpose under the plan, and any excess is returned to the employer when all liabilities are satisfied. Section 2 of this Act also amends section 404 to make it clear that this provision applies to insured plans as well as to trusteed plans. These amendments are effective for all taxable years beginning after October 23, 1962.

New option to deduct intangible drilling and development costs.—Section 3 of this Act permits taxpayers to exercise a new option to deduct intangible drilling and development costs as expenses if they had previously exercised an option to capitalize these costs for a tax year to which the Internal Revenue Code of 1939 applies under the regulations approved by Congress in H. Con. Res. 50, or under section 39.23(m)-16 of Regulations 118. This new option, if exercised, applies only for taxable years ending after October 22, 1962, and must be exercised at the time the income tax return is filed for the first taxable year ending after that date. The new option if exercised shall be binding for all future years.

7608

Authority of internal revenue enforcement officers.—This Act amends section 7608 of the Code, relating to the enforcement of subtitle E of the Code and other laws pertaining to liquor, tobacco, and firearms, by adding new provisions under which special agents of the Intelligence Division and inspectors of the Internal Security Division of the Service are authorized in the performance of their duties to execute and serve search warrants and arrest warrants and to serve subpoenas and summonses issued under authority of the United States. These officers of the Service are also authorized to make an arrest without a warrant for any United States internal revenue offense committed in their presence, or for such an offense that is a felony, if they have reason to believe the person to be arrested has committed or is committing any such felony. Finally, they may seize property which, under internal revenue laws, is subject to forfeiture.

These amendments became effective on October 24, 1962.

1341(b)

Computation of tax where taxpayer restores substantial amount held under claim of right.—Section 1341 provides for a computation of tax for a taxable year in which the taxpayer restores an amount held under a claim of right under either of the two methods prescribed which produces the lesser amount of tax. Prior to the amendment made to subsection (b) of section 1341, made by section 5 of the Act, taxpayers could find themselves in a worse position than if section 1341 had not been enacted, by reason of the treatment of a net operating loss (or a capital loss) for either the taxable year or for prior years.

Section 5 of the Act added two new paragraphs ((4) and (5)) at the end of subsection (b) of section 1341 which provide more liberal rules for the treatment of such losses. Under such provisions, in computing the amount of tax under section 1341(a)(4) (the first method) a net operating loss for the taxable year is to be carried back to the extent and in the manner provided under section 172; similarly, in

computing the amount of tax under section 1341(a)(5) (the second method) a net operating loss (or capital loss) for a prior taxable year is to be carried back and carried over to the extent and in the manner provided under section 172 (or 1212), except that no carryover beyond the taxable year shall be taken into account. This treatment of net operating loss (or capital loss) is only for the purpose of determining which method (section 1341(a) (4) or (5)) results in the lesser amount of tax for the taxable year. Once that has been determined, a net operating loss resulting from the computation under section 1341(a) (4), or a net operating loss (or capital loss) resulting from the computation under section 1341 (a)(5), as the case may be, is to be taken into account under section 172 (or 1212) for taxable years after the taxable year to the same extent and in the same manner as a net operating loss sustained in the taxable year if section 1341(a)(4) is applied or as a net operating loss (or capital loss) sustained in the prior taxable year (or years) if section 1341(a)(5) is applied. The provision in section 1341(b)(3) is not changed; thus, if the tax is determined under section 1341(a)(5), the deduction described in section 1341(a) (2) is not to be taken into account for any other purpose of the Code, such as, for computing (or increasing) a net operating loss for the taxable year.

The amendment made by this Act is effective for taxable years beginning on or after January 1, 1962.

Public Law 87–870 (page 213).

281

Terminal railroad corporations and their shareholders.—Prior to this amendment, a corporation operating a railroad terminal and providing terminal and switching facilities and services primarily to railroad corporations may have been taxed on its profits even though it used these profits by charging its shareholder railroads for services at less than cost. In addition, each shareholder railroad may have been allowed a deduction for the full cost of services rendered to it and treated as if it had received a dividend in the amount of the undercharge. Section 1 of this Act adds a new section 281 to the Code which provides that if, pursuant to a written agreement, as a result of taking income related to the operation of a railroad terminal into account a terminal railroad corporation either (i) reduces the amount that it would have charged for terminal services performed for any railroad corporation, or (ii) reduces a charge it had previously made for such services, then the terminal railroad corporation is to be neither taxed on, nor disallowed a deduction for, the portion of the charge which is so reduced. Similarly, a railroad shareholder of the terminal railroad corporation is not to be treated as having received a dividend, nor is it to be allowed a deduction, for the portion of the charge which is so reduced. For years ending after enactment, section 281 is not to apply to the extent that it would create (or increase) a net operating loss of the terminal railroad corporation. For years ending before enactment, section 281 is to apply only to the extent that the terminal railroad corporation and each shareholder originally reported its taxable income as if it were then law. Special rules are

provided for application to closed years. Section 2 of this Act makes section 281 applicable to all years to which the Internal Revenue Codes of 1954 and 1939 apply.

7515, 7516, 7809

Moneys received in payment for certain services to be deposited in a separate account which may be used to reimburse appropriations which bore the cost of such services.—Section 3 of this Act adds new sections 7515 and 7516, which authorize the Secretary or his delegate, upon request and payment of the costs of the work, to make special statistical studies and compilations involving data from returns and Service records, and to supply training and training aids to employees of States, United States possessions, and foreign governments. This section of the Act also amends section 7809 to provide, as an exception to the general rule that collections received under authority of any internal revenue law shall be paid into the general funds, that moneys received in payment for such statistical studies or such training and training aids shall be deposited in a separate account which may be used to reimburse appropriations which bore the costs of such services. This provision for deposit in a separate account which may be used to reimburse appropriations is also made applicable to moneys received in payment for work or services performed for a State or a department or agency of the Federal Government in supplying (subject to all provisions of law and regulations governing disclosure of information) copies of, or data from, returns and other documents filed with the Service or records maintained by the Service.

6512(b)(2)

Correction of procedural defect in the operation of Code sections 6512(b)(2) and 7422(e).—Section 4 of this Act corrects a procedural defect in the operation of Code sections 6512(b)(2) and 7422(e). Before amendment section 6512(b)(2) provided that no refund of an overpayment determined by the Tax Court shall be allowed unless the Tax Court also determines that the overpayment was paid either (1) after the mailing of the notice of deficiency which originally gave jurisdiction to the Tax Court, or (2) at such a time that the taxpayer could have filed a timely claim for refund on the date the notice of deficiency was mailed. This provision worked satisfactorily in all cases except where the period of limitation on the Commissioner's right to issue a deficiency notice was longer than the period of limitation on filing a claim for refund. In the latter case, however, a refund based on a timely claim could have been barred by the technical wording of section 6512(b)(2) because, even though an actual claim for refund had been filed before the mailing of the notice of deficiency, the period of limitation on filing a claim could have expired by the time the notice of deficiency was mailed. This amendment corrects this defect by adding provisions to section 6512(b)(2) which specifically protect the taxpayer who has previously filed a valid claim.

7701(a)(32)

Section 5 of this Act adds a new paragraph to section 7701(a) of the Code to define the term "cooperative bank". As so defined, a cooperative bank is an institution without capital stock organized and operated

for mutual purposes and without profit which meets the same general conditions prescribed for qualification of an institution as a domestic building and loan association under section 7701(a) (19) of the Code, as amended by section 6(c) of the Revenue Act of 1962. The amendment is effective for taxable years beginning after October 16, 1962.

Public Law 87–876 (page 217).

37(d)

Limitation on retirement income.—Section 37 of the Code was originally enacted to give those who have retirement income, but do not receive social security or similar types of tax-exempt benefit payments, a tax exemption of approximately the same size as that received by social security beneficiaries. At the time of enactment the terms of the retirement income credit corresponded approximately with those of the social security benefits. This Act amends section 37(d) so as to update the credit under section 37 to more nearly correspond to the social security program. The maximum amount of retirement income which may be taken into account in computing the credit is raised from $1,200 to $1,524. In addition, instead of earned income in excess of $1,200 reducing the retirement income eligible for the credit (on a dollar-for-dollar basis) the dollar-for-dollar reduction under the amendment made by the Act will occur only for earnings above $1,700; for earnings between $1,200 and $1,700, the retirement income will be reduced by 50 cents for every dollar of earnings. Moreover, for those retiring under public retirement programs, this new reduction for earned income will apply to those age 62 or over rather than 65 or over as under prior law; for those under a public retirement program below age 62, the $900 floor for a reduction arising from earned income continues to apply, the same as under prior law.

The amendments made by the Act are applicable in computing the retirement income credit under section 37 for taxable years ending after October 24, 1962.

461

Dividends or interest paid on certain withdrawable accounts.—Section 3 of this Act amends section 461 of the Code to provide, for taxable years ending after December 31, 1962, for the disallowance as a deduction for a taxable year of amounts paid or credited, by building and loan associations, etc., to the accounts of depositors or holders of accounts as dividends or interest on their deposits or withdrawable accounts which are for periods representing more than 12 months. Any amount not allowed as deduction for a taxable year may be allowed as a deduction for such other taxable year as the Secretary or his delegate may determine.

INTERNAL REVENUE CODE OF 1939

Public Law 87–834 (page 111).

188

Continuation of a partnership year for surviving partner in a two-man partnership where one dies.—Section 188 of the 1939 Code is

amended to provide that the death of one of the partners in a two-man partnership will not result in the termination of the partnership or the closing of the partnership taxable year with respect to the surviving partner, if the surviving partner so elects within one year after October 16, 1962. The provisions applies to partnership taxable years beginning after December 31, 1946, to which the Internal Revenue Code of 1939 applies. Provision is made for application to closed years.

MISCELLANEOUS PUBLIC LAWS

Public Law 87–520 (page 64).

Extension of Renegotiation Act of 1951.—This Act provides for a 2-year extension of the Renegotiation Act of 1951 from June 30, 1962, to June 30, 1964. It also modifies section 108A of the Renegotiation Act by authorizing the review of Tax Court decisions in renegotiation cases by the United States Courts of Appeals, but only with respect to cases in which the petition for redetermination is filed with the Tax Court after July 3, 1962.

Public Law 87–629 (page 65).

Termination of Federal Jurisdiction of the Ponca Indians.—This Act provides for the termination of Federal jurisdiction of the Ponca Tribe of Native Americans of Nebraska. The Secretary of the Interior is directed to prepare a roll of the members of the Ponca Tribe who are on the census roll of April 1, 1934, as supplemented as of January 1, 1935, and their descendants of at least one-quarter degree Indian blood of the Ponca Tribe living on the date of this Act. If a majority of the adult members of the tribe enrolled agree to a division of the tribal assets as the Act provides, each member on the final roll would be entitled to an equal share of the tribe's assets held in trust by the United States. Section 8 of the Act provides that the property distributed under the Act may not be subject to Federal or State income tax; but after distribution, the property and income from it are subject to the same State and Federal taxes as it would be for non-Indians. For the purpose of capital gains or losses, the basis of the property will be the value of the property when distributed to the grantee.

Public Law 87–734 (page 71).

Payments by the United States to the Lower Brule Sioux Indians.—This Act exempts from all forms of State and Federal taxation all funds paid by the United States under authority of the Act to the Lower Brule Sioux Tribe and individual Indians. Part of the funds are for the taking of certain tribally- and individually-owned Indian lands, excluding interests in all minerals except gravel, on the Lower Brule Sioux Reservation, South Dakota. These lands are within the taking area of the Big Bend Dam and Reservoir Project authorized by the Flood Control Act of December 22, 1944 (58 Stat. 887, 891). United States interests in such minerals in land previously taken for the Big Bend Project are revested in the former owners under the Act. Also, this Act authorizes the appropriation of $1,968,750 for generally improving the economic and social conditions of the

members of the tribe enrolled on the date of its enactment. The Secretary of the Army is directed to relocate Indian cemeteries, tribal monuments, etc., that are within the taking area using funds appropriated for the Big Bend Project. Individual Indians and the tribe, up to within 60 days before they are required to vacate the taking area, may salvage timber and improvements from their respective lands. The Secretary of the Treasury is directed, upon certification by the Secretary of the Interior, to reimburse the tribe for expenses incurred in regard to the taking of the reservation lands within the Big Bend Project.

Public Law 87–735 (page 78).

Payments by the United States to the Crow Creek Sioux Indians.—This Act exempts from all forms of State and Federal taxation all funds paid by the United States under authority of the Act to the Crow Creek Sioux Tribe and individual Indians. Part of the funds are for the taking of certain tribally- and individually-owned Indian lands, excluding interests in all minerals except gravel, on the Crow Creek Sioux Reservation, South Dakota. These lands are within the taking area of the Big Bend Dam and Reservoir Project authorized by the Flood Control Act of December 22, 1944 (58 Stat. 887, 891). United States interests in such minerals in land previously taken for the Big Ben Project are revested in the former owners under the Act. Also, this Act authorizes the appropriation of $3,-802,500 for generally improving the economic and social conditions of the members of the tribe enrolled on the date of its enactment. The Secretary of the Army is directed to relocate Indian Cemeteries, tribal monuments etc., that are within the taking area using funds appropriated for the Big Bend Project. Individual Indians and the tribe, up to within 60 days before they are required to vacate the taking area, may salvage timber and improvements from their respective lands. The Secretary of the Treasury is directed, upon certification by the Secretary of the Interior, to reimburse the tribe for expenses incurred in regard to taking of the reservation lands within the Big Bend Project.

Public Law 87–775 (page 86).

Disposition of Certain Judgment Funds of the Cherokee Nation or Tribe of Indians of Oklahoma.—This Act directs the Secretary of the Interior to distribute certain judgment funds on a per capita basis to persons named on the rolls of the Cherokee Nation or their heirs or legatees. These rolls were closed as of March 4, 1907. The funds were appropriated by the Act of September 30, 1961 (75 Stat. 733), to satisfy a judgment obtained by the Cherokee Tribe in the Indian Claims Commission against the United States. The Act further provides that the funds distributed are not subject to Federal or State income tax or held to be "other income and resources" as this term is used in sections 2(a)(10)(A), 402(a)(7), 1002(a)(8), and 1402(a)(8) of the Social Security Act (42 U.S.C. 302(a)(10)(A), 602(a)(7), 1202(a)(8), and 1352(a)(8)).

Public Law 87–846 (page 205).

Exemption of Certain War Claims Act Awards.—Section 206(b) of this Act provides an exemption from tax for certain awards received by a corporation under the War Claims Act of 1948 (as amended). The Act provides that awards in excess of $10,000 shall be reduced by the tax benefit realized by the corporation as a result of the deduction from income of the losses with respect to which the claim is filed. Any payments received on an award so reduced are exempt from tax.

Public Law 87–859 (page 210).

Extended suspension of the excise tax on the first domestic processing of coconut oil, palm oil, palm-kernel oil, and fatty acids, salts, and combinations or mixtures thereof.—This Act amends section 3 of Public Law 85–235, approved August 30, 1957 (C.B. 1957–2, 1061) and Public Law 86–37, approved May 29, 1959 (C.B. 1959–2, 654) so as to extend the present suspension of the tax imposed under section 4511(a) of the Code, relating to the first domestic processing of coconut oil, palm oil, palm-kernel oil, etc., from June 30, 1963 to June 30, 1966. (Note: Under Public Law 87–456 approved May 24, 1962 (page 57), Code section 4511 will be repealed effective on the tenth day after the date of the issuance of a specified Presidential proclamation relating to tariffs.)

PART II

TAX LEGISLATION

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PART II

TAX LEGISLATION

PUBLIC LAW 87–456
EIGHTY-SEVENTH CONGRESS, MAY 24, 1962
H.R. 10607 [1]

An Act to amend the Tariff Act of 1930 and certain related laws to provide for the restatement of the tariff classification provisions, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Tariff Classification Act of 1962".

TITLE I—ADOPTION OF REVISED TARIFF SCHEDULES

*   *   *   *   *   *   *

SEC. 102. At the earliest practicable date, the President shall take such action as he deems necessary to bring the United States schedules annexed to foreign trade agreements into conformity with the Tariff Schedules of the United States and, after such action is completed, the President shall proclaim—

(1) the rates of duty in rate column numbered 1 of schedules 1 to 7, inclusive, and the other provisions of the Tariff Schedules of the United States, which are required or appropriate to carry out the foreign trade agreements to which the United States is a contracting party;

(2) the temporary modifications set forth in part 2 of the appendix to the tariff schedules (that is, those modifications proclaimed pursuant to the provisions of section 7 of the Trade Agreements Extension Act of 1951, as amended (19 U.S.C. 1364), and of other trade-agreements legislation);

(3) the additional import restrictions set forth in part 3 of the appendix to the tariff schedules (that is, those restrictions proclaimed pursuant to section 22 of the Agricultural Adjustment Act, as amended (7 U.S.C. 624)); and

(4) the nations or areas and countries set forth in general headnote 3(d) of the Tariff Schedules of the United States (relating to the treatment of products of certain Communist-dominated nations or areas and countries discriminating against American commerce).

*   *   *   *   *   *   *

[1] This publication of the law is restricted to excerpts involving internal revenue matters; House Report No. 1415, and Senate Report No. 1317, are not published herein.

TITLE III—AMENDMENTS AND REPEALS

* * * * * * *

Sec. 302. (a) The first sentence of section 4501(a) of the Internal Revenue Code of 1954 is amended to read as follows: "There is hereby imposed upon manufactured sugar manufactured in the United States, a tax, to be paid by the manufacturer at the rate of 0.53 cent per pound of the total sugars therein."

(b) Section 4501(b) of such Code is hereby repealed. Subsection (c) of section 4501 of such Code is redesignated as subsection (b), and such subsection is amended—

(1) by striking out "manufacture, use, or importation" in the first sentence thereof and inserting in lieu thereof "manufacture or use"; and

(2) by striking out "subsection (a) or (b)" in the second sentence thereof and inserting in lieu thereof "subsection (a)".

(c) Section 6418(b) of such Code is amended by striking out "; except that no such payment shall be allowed with respect to any manufactured sugar, or article, upon which, through substitution or otherwise, a drawback of any tax paid under section 4501(b) has been or is to be claimed under any provisions of law made applicable by section 4504".

(d) Sections 4504, 4511, 4512, 4513, 4514, 4521, 4531, 4532, 4541, 4542, 4551, 4552, 4553, 4561, 4562, 4571, 4572, 4581, 4582, 4601, 4602, 4603, 6412(d) and 7511 of such Code are hereby repealed and the tables of sections for such Code are correspondingly amended.

* * * * * * *

TITLE V—EFFECTIVE DATE

Sec. 501. (a) Except as provided in subsection (b), the repeal of titles I and II of the Tariff Act of 1930 and the substitution of a new title I therefor, as provided for in title I of this Act, and the provisions of title III of this Act shall become effective with respect to articles entered, or withdrawn from warehouse, for consumption on or after the 10th day following the date of the proclamation of the President provided for in section 102.

(b) The amendment made by section 302(a) shall become effective on the 10th day following the date of the proclamation of the President provided for in section 102.

Approved May 24, 1962.

PUBLIC LAW 87–508
EIGHTY-SEVENTH CONGRESS, JUNE 28, 1962
H.R. 11879 [2]

An Act to provide a one-year extension of the existing corporate normal-tax rate and of certain excise-tax rates, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Tax Rate Extension Act of 1962".

[2] House Report No. 1738, page 221, this Bulletin ; Senate Report No. 1616, page 228, this Bulletin ; Conference Report No. 1935, page 235, this Bulletin ; Senate Report No. 1604, not published herein.

Sec. 2. One-Year Extension of Corporate Normal-Tax Rate.

Section 11(b) (relating to corporate normal tax), section 821(a)(1)(A) (relating to mutual insurance companies other than interinsurers), and section 821(b)(1) (relating to interinsurers) of the Internal Revenue Code of 1954 are amended as follows:

(1) By striking out "July 1, 1962" each place it appears and inserting in lieu thereof "July 1, 1963";
(2) By striking out "July 1, 1962" each place it appears and inserting in lieu thereof "June 30, 1963".
(3) By striking out "June 30, 1962" each place it appears and inserting in lieu thereof "June 30, 1963"; and
(4) By striking out "June 30, 1962" each place it appears and inserting in lieu thereof "June 30, 1963."

Sec. 3. One-Year Extension of Certain Excise-Tax Rates.

(a) Extension of Rates.—The following provisions of the Internal Revenue Code of 1954 are amended by striking out "July 1, 1962" each place it appears and inserting in lieu thereof "July 1, 1963"—

(1) section 4061 (relating to motor vehicles);
(2) section 4251(b)(2) (relating to termination of tax on general telephone service);
(3) section 5001(a)(1) (relating to distilled spirits);
(4) section 5001(a)(3) (relating to imported perfumes containing distilled spirits);
(5) section 5022 (relating to cordials and liqueurs containing wine);
(6) section 5041(b) (relating to wines);
(7) section 5051(a) (relating to beer); and
(8) section 5701(c)(1) (relating to cigarettes).

(b) Technical Amendments.—The following provisions of the Internal Revenue Code of 1954 are amended as follows:

(1) Section 5063 (relating to floor stocks refunds on distilled spirits, wines, cordials, and beer) is amended by striking out "July 1, 1962" each place it appears and inserting in lieu thereof "July 1, 1963", and by striking out "October 1, 1962" and inserting in lieu thereof "October 1, 1963".
(2) Subsections (a) and (b) of section 5707 (relating to floor stocks refunds on cigarettes) are amended by striking out "July 1, 1962" each place it appears and inserting in lieu thereof "July 1, 1963", and by striking out "October 1, 1962" and inserting in lieu thereof "October 1, 1963".
(3) Section 6412(a)(1) (relating to floor stocks refunds on automobiles) is amended by striking out "July 1, 1962" each place it appears and inserting in lieu thereof "July 1, 1963", by striking out "October 1, 1962" and inserting in lieu thereof "October 1, 1963", and by striking out "November 10, 1962" each place it appears and inserting in lieu thereof "November 10, 1963".

Section 497 of the Revenue Act of 1951 (relating to refunds on articles from foreign trade zones), as amended, is amended by striking out "July 1, 1962" each place it appears and inserting in lieu thereof "July 1, 1963".

Sec. 4. Exemption From Communications Tax of Certain Private Line Services Used in Conduct of Trade or Business.

(a) Wire Mileage Service.—Section 4252(e) of the Internal Revenue Code of 1954 (relating to definition of wire mileage service) is amended by striking out paragraphs (1) and (2) and inserting in lieu thereof the following:

"(1) any telephone or radiotelephone service not used in the conduct of a trade or business, and

"(2) any other wire or radio circuit service not used in the conduct of a trade or business,".

(b) General Telephone Service.—Section 4253 of such Code (relating to exemptions from the communications tax) is amended by adding at the end thereof the following new subsection:

"(j) Certain Private Communications Services.—No tax shall be imposed under section 4251 on any amount paid for the use of any telephone or radiotelephone line or channel which constitutes general telephone service (within the meaning of section 4252(a)), if—

"(1) such line or channel is furnished between specified locations in different States or between specified locations in different counties, municipalities, or similar political subdivisions of a State, and

"(2) such use is in the conduct of a trade or business."

(c) Effective Date.—The amendments made by subsections (a) and (b) shall apply with respect to services furnished on or after January 1, 1963.

Sec. 5. Extension Through November 15, 1962, of Tax on Transportation of Persons, and Further Extension of Tax on Transportation of Persons by Air at 5-Percent Rate for Period November 16, 1962, Through June 30, 1963.

(a) Temporary Extension of Tax.—Section 4261 of the Internal Revenue Code of 1954 (relating to the imposition of tax on the transportation of persons) is amended—

(1) by striking out everything after "equal to" in subsections (a) and (b) and inserting in lieu thereof "10 percent of the amount so paid for transportation which begins before November 16, 1962."; and

(2) by striking out everything after "equivalent to" in subsection (c) and inserting in lieu thereof "10 percent of the amount so paid in connection with transportation which begins before November 16, 1962."

(b) Tax Applicable to Transportation of Persons by Air for Period November 16, 1962, to July 1, 1963.—Effective with respect to transportation beginning after November 15, 1962, subchapter C of chapter 33 of such Code (relating to the tax on the transportation of persons) is amended to read as follows:

"Subchapter C—Transportation of Persons by Air

"SEC. 4261. IMPOSITION OF TAX.

"(a) Amounts Paid Within the United States.—There is hereby imposed upon the amount paid within the United States for taxable transportation (as defined in section 4262) of any person by air a tax equal to 5 percent of the amount so paid for transportation which begins after November 15, 1962, and before July 1, 1963.

"(b) Amounts Paid Outside the United States.—There is hereby imposed upon the amount paid without the United States for taxable transportation (as defined in section 4262) of any person by air, but only if such transportation begins and ends in the United States, a tax equal to 5 percent of the amount so paid for transportation which begins after November 15. 1962, and before July 1, 1963.

"(c) Seats, Berths, etc.—There is hereby imposed upon the amount paid for seating or sleeping accommodations in connection with transportation with respect to which a tax is imposed by subsection (a) or (b) a tax equivalent to

5 percent of the amount so paid in connection with transportation which begins after November 15, 1962, and before July 1, 1963.

"(d) By Whom Paid.—Except as provided in section 4264, the taxes imposed by this section shall be paid by the person making the payment subject to the tax.

"SEC. 4262. DEFINITION OF TAXABLE TRANSPORTATION.

"(a) Taxable Transportation; in General.—For purposes of this subchapter, except as provided in subsection (b), the term 'taxable transportation' means—

"(1) transportation which begins in the United States or in the 225-mile zone and ends in the United States or in the 225-mile zone; and

"(2) in the case of transportation other than transportation described in paragraph (1), that portion of such transportation which is directly or indirectly from one port or station in the United States to another port or station in the United States, but only if such portion is not a part of uninterrupted international air transportation (within the meaning of subsection (c)(3)).

"(b) Exclusion of Certain Travel.—For purposes of this subchapter, the term 'taxable transportation' does not include that portion of any transportation which meets all 4 of the following requirements:

"(1) such portion is outside the United States;

"(2) neither such portion nor any segment thereof is directly or indirectly—

"(A) between (i) a point where the route of the transportation leaves or enters the continental United States, or (ii) a port or station in the 225-mile zone, and

"(B) a port or station in the 225-mile zone;

"(3) such portion—

"(A) begins at either (i) the point where the route of the transportation leaves the United States, or (ii) a port or station in the 225-mile zone, and

"(B) ends at either (i) the point where the route of the transportation enters the United States, or (ii) a port or station in the 225-mile zone; and

"(4) a direct line from the point (or the port or station) specified in paragraph (3)(A), to the point (or the port or station) specified in paragraph (3)(B), passes through or over a point which is not within 225 miles of the United States.

"(c) Definitions.—For purposes of this section—

"(1) Continental united states.—The term 'continental United States' means the District of Columbia and the States other than Alaska and Hawaii.

"(2) 225-mile zone.—The term '225-mile zone' means that portion of Canada and Mexico which is not more than 225 miles from the nearest point in the continental United States.

"(3) Uninterrupted international air transportation.—The term 'uninterrupted international air transportation' means any transportation by air which is not transportation described in subsection (a)(1) and in which—

"(A) the scheduled interval between (i) the beginning or end of the portion of such transportation which is directly or indirectly from one port or station in the United States to another port or station in the United States and (ii) the end or beginning of the other portion of such transportation is not more than 6 hours, and

"(B) the scheduled interval between the beginning or end and the end or beginning of any two segments of the portion of such transportation referred to in subparagraph (A)(i) is not more than 6 hours.

"SEC. 4263. EXEMPTIONS.

"(a) Commutation Travel, etc.—The tax imposed by section 4261 shall not apply to amounts paid for transportation which do not exceed 60 cents, to amounts paid for commutation or season tickets for single trips of less than 30 miles, or to amounts paid for commutation tickets for one month or less.

"(b) Certain Organizations.—The tax imposed by section 4261 shall not

apply to the payment for transportation or facilities furnished to an international organization, or any corporation created by Act of Congress to act in matters of relief under the treaty of Geneva of August 22, 1864.

"(c) MEMBERS OF THE ARMED FORCES.—The tax imposed by section 4261 shall not apply to the payment for transportation or facilities furnished under special tariffs providing for fares of not more than 2.5 cents per mile applicable to round-trip tickets sold to personnel of the United States Army, Air Force, Navy, Marine Corps, and Coast Guard traveling in uniform of the United States at their own expense when on official leave, furlough, or pass, including authorized cadets and midshipmen, issued on presentation of properly executed certificate.

"(d) SMALL AIRCRAFT ON NONESTABLISHED LINES.—The tax imposed by section 4261 shall not apply to transportation by aircraft having—

"(1) a gross takeoff weight (as determined under regulations prescribed by the Secretary or his delegate) of less than 12,500 pounds, and

"(2) a passenger seating capacity of less than ten adult passengers, including the pilot,

except when such aircraft is operated on an established line.

"SEC. 4264. SPECIAL RULES.

"(a) PAYMENTS MADE OUTSIDE THE UNITED STATES FOR PREPAID ORDERS.—If the payment upon which tax is imposed by section 4261 is made outside the United States for a prepaid order, exchange order, or similar order, the person furnishing the initial transportation pursuant to such order shall collect the amount of the tax.

"(b) TAX DEDUCTED UPON REFUNDS.—Every person who refunds any amount with respect to a ticket or order which was purchased without payment of the tax imposed by section 4261 shall deduct from the amount refundable, to the extent available, any tax due under such section as a result of the use of a portion of the transportation purchased in connection with such ticket or order, and shall report to the Secretary or his delegate the amount of any such tax remaining uncollected.

"(c) PAYMENT OF TAX.—Where any tax imposed by section 4261 is not paid at the time payment for transportation is made, then, under regulations prescribed by the Secretary or his delegate, to the extent that such tax is not collected under any other provision of this subchapter—

"(1) such tax shall be paid by the person paying for the transportation or by the person using the transportation;

"(2) such tax shall be paid within such time as the Secretary or his delegate shall prescribe by regulations after whichever of the following first occurs:

"(A) the rights to the transportation expire; or

"(B) the time when the transportation becomes subject to tax; and

"(3) payment of such tax shall be made to the Secretary or his delegate, to the person to whom the payment for transportation was made, or, in the case of transportation other than transportation described in section 4262(a)(1), to any person furnishing any portion of such transportation.

"(d) APPLICATION OF TAX.—The tax imposed by section 4261 shall apply to any amount paid within the United States for transportation of any person by air unless the taxpayer establishes, pursuant to regulations prescribed by the Secretary or his delegate, at the time of payment for the transportation, that the transportation is not transportation in respect of which tax is imposed by section 4261.

"(e) ROUND TRIPS.—In applying this subchapter to a round trip, such round trip shall be considered to consist of transportation from the point of departure to the destination, and of separate transportation thereafter.

"(f) TRANSPORTATION OUTSIDE THE NORTHERN PORTION OF THE WESTERN HEMISPHERE.—In applying this subchapter to transportation any part of which is outside the northern portion of the Western Hemisphere, if the route of such transportation leaves and reenters the northern portion of the Western Hemisphere, such transportation shall be considered to consist of transportation to a point outside such northern portion, and of separate transportation thereafter. For purposes of this subsection, the term 'northern portion of the Western Hemisphere means the area lying west of the 30th meridian west of Greenwich, east of the international dateline, and north of the Equator, but not including any country of South America."

(c) CONFORMING AMENDMENTS.—

(1) The table of subchapters for chapter 33 of such Code is amended by striking out

"SUBCHAPTER C. Transportation of persons."

and inserting in lieu thereof

"SUBCHAPTER C. Transportation of persons by air."

(2) Section 6421 of such Code (relating to gasoline used for certain nonhighway purposes or by local transit systems) is amended as follows:

(A) Subsection (b) (relating to use by local transit systems) is amended—

(i) by striking out "tax-exempt passenger fare revenue" and inserting in lieu thereof "commuter fare revenue" each place it appears therein; and

(ii) by striking out "(not including the tax imposed by section 4261, relating to the tax on transportation of persons)" each place it appears therein.

(B) Subsection (d)(2) (defining tax-exempt passenger fare revenue) is amended to read as follows:

"(2) COMMUTER FARE REVENUE.—The term 'commuter fare revenue' means revenue attributable to fares derived from the transporation of persons and attributable to—

"(A) amounts paid for transportation which do not exceed 60 cents,

"(B) amounts paid for commutation or season tickets for single trips of less than 30 miles, or

"(C) amounts paid for commutation tickets for one month or less."

(3) Section 6416(b)(2)(H) of such Code (relating to special cases in which tax payments considered overpayments for credit or refund purposes) is amended—

(A) by striking out "tax-exempt passenger fare revenue" and inserting in lieu thereof "commuter fare revenue"; and

(B) by striking out "(not including the tax imposed by section 4261, relating to the tax on transportation of persons)".

(d) EFFECTIVE DATES.—The amendment made by subsection (c)(1) shall apply only with respect to transportation beginning after November 15, 1962. The amendments made by subsection (c)(2) shall apply only in respect of claims filed with respect to gasoline used on or after November 16, 1962. The amendments made by subsection (c)(3) shall apply only in respect to the use or sale of special fuels made on or after November 16, 1962.

(e) SPECIAL CREDIT OR REFUND OF TRANSPORTATION TAX.—Notwithstanding any other provision of law, in any case in which tax has been collected—

(1) before November 16, 1962, for or in connection with the transportation of persons which begins on or after November 16, 1962, or

(2) after November 15, 1962, and before July 1, 1963, for or in connection with the transportation of persons by air which begins on or after July 1, 1963,

the person who collected the tax shall pay the same over to the United States; but credit or refund (without interest) of the tax collected in excess of that applicable (by reason of the amendments made by this section) shall be allowed to the person who collected the tax as if

such credit or refund were a credit or refund under the applicable provision of the Internal Revenue Code of 1954, but only to the extent that, before the time such transportation has begun, he has repaid the amount of such excess to the person from whom he collected the tax, or has obtained the consent of such person to the allowance of the credit or refund. For the purpose of this subsection, transportation shall not be considered to have begun on or after November 16, 1962, or on or after July 1, 1963, as the case may be, if any part of the transportation paid for (or for which payment has been obligated) commenced before such date.

Approved June 28, 1962.

PUBLIC LAW 87–520
EIGHTY-SEVENTH CONGRESS, JULY 3, 1962
H.R. 12061 [3]

An Act to extend the Renegotiation Act of 1951, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 102(c)(1) of the Renegotiation Act of 1951, as amended (50 U.S.C. App. 1212(c)(1)), is amended by striking out "June 30, 1962" and inserting in lieu thereof "June 30, 1964".

Sec. 2. (a) Section 108A of the Renegotiation Act of 1951, as amended (50 U.S.C., App., sec. 1218a), is amended to read as follows:

SEC. 108A. REVIEW OF TAX COURT DECISIONS IN RENEGOTIATION CASES

(a) Jurisdiction.—Except as provided in section 1254 of title 28 of the United States Code, the United States Courts of Appeals shall have exclusive jurisdiction to review decisions by the Tax Court of the United States under section 108 of this Act in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury, except as otherwise provided in this section. In no case shall the question of the existence of excessive profits, or the extent thereof, be reviewed, and findings of fact by the Tax Court shall be conclusive unless such findings are arbitrary or capricious. The judgment of any such court shall be final except that it shall be subject to review, under the limitations herein provided for, by the Supreme Court of the United States upon certiorari, in the manner provided in section 1254 of title 28 of the United States Code.

(b) Powers.—Upon such review, such courts shall have only the power to affirm the decision of the Tax Court or to reverse such decision on questions of law and remand the case for such further action as justice may require, except that such court shall not reverse and remand the case for error of law which is immaterial to the decision of the Tax Court.

(c) Venue of Appeals From Tax Court Decisions in Renegotiation Cases.—A decision of the Tax Court of the United States under section 108 of this Act may, to the extent subject to review, be reviewed by—

(1) the United States Court of Appeals for the circuit in which is located the office to which the contractor or subcontractor made his Federal income tax return for the taxable year which corresponds to the fiscal year with respect to which such decision of the Tax Court was made, or if no such return was made for such taxable year, then by the United States Court of Appeals for the District of Columbia, or

(2) any United States Court of Appeals designated by the Attorney General and the contractor or subcontractor by stipulation in writing.

(b) The second sentence of section 108 of such Act is amended to read as follows: "Upon such filing, such court shall have exclusive jurisdiction, by order, to determine the amount, if any, of such exces-

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[3] Senate Report No. 1669, page 239, this Bulletin.

sive profits received or accrued by the contractor or subcontractor, and such determination shall not be reviewed or redetermined by any court or agency except as provided in section 108A."

(c) Section 105(b)(2) of such Act is amended by striking out the last sentence thereof.

(d) The amendments made by this section shall apply only with respect to cases in which the petition for redetermination is filed with the Tax Court of the United States after the date of the enactment of this Act.

Approved July 3, 1962.

PUBLIC LAW 87-535
EIGHTY-SEVENTH CONGRESS, JULY 13, 1962
H.R. 12154[4]

An Act to amend and extend the provisions of the Sugar Act of 1948, as amended.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Sugar Act Amendment of 1962".

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SEC. 18. (a) Section 4501(c) (relating to termination of taxes on sugar) of the Internal Revenue Code of 1954 is amended by striking out "December 31, 1962" in each place it appears therein and inserting in lieu thereof "June 30, 1967".

(b) Section 6412(d) (relating to refund of taxes on sugar) of the Internal Revenue Code of 1954 is amended by striking out "December 31, 1962" and inserting in lieu thereof "June 30, 1967" and by striking out "March 31, 1963" and inserting in lieu thereof "September 30, 1967".

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Approved July 13, 1962.

PUBLIC LAW 87-629
EIGHTY-SEVENTH CONGRESS, SEPTEMBER 5, 1962
H.R. 3174[5]

An Act to provide for the division of the tribal assets of the Ponca Tribe of Native Americans of Nebraska among the members of the tribe, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the Secretary of the Interior shall, with the advice and assistance of the Ponca Tribe of Native Americans of Nebraska and pursuant to such regulations as he may prescribe, prepare a roll of the members of the tribe and record thereon persons whose names appeared on the census roll of April 1, 1934, and the supplement thereto of January 1, 1935, and their descendants of not less than one-quarter degree Indian blood of the Ponca Tribe, regardless of place of residence, who are living on the date of

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[4] This publication of the law is restricted to excerpts involving internal revenue matters; House Report No. 1829, Senate Report No. 1631 and Conference Report No. 1957 are not published herein.

[5] House Report No. 2076 and Senate Report No. 1623 are not published herein.

this Act. He shall provide a reasonable opportunity for any person to protest against the inclusion or omission of any name on or from the roll and his decision on such protests shall be final and conclusive. After all protests are disposed of, the roll shall be published in the Federal Register. The Secretary shall thereupon give the adult members of the tribe whose names appear on the roll an opportunity to indicate their agreement or disagreement with a division of tribal assets in accordance with the provisions of this Act. If a majority of those indicating agreement or disagreement are favorable to such division, the Secretary shall publish in the Federal Register a notice of the fact and the roll prepared by him shall thereupon become final and the following sections of this Act shall become effective.

Sec. 2. Each member whose name appears on the final roll of the tribe as published in the Federal Register shall be entitled to receive in accordance with the provisions of this Act an equal share of the tribe's assets that are held in trust by the United States. This right shall constitute personal property which may be inherited or bequeathed, but it shall not otherwise be subject to alienation or encumbrance.

Sec. 3. (a) All property of the United States used for the benefit of the Ponca Tribe of Native Americans of Nebraska is hereby declared to be a part of the assets of the tribe, and all of the tribe's assets shall be distributed in accordance with the provisions of this section. The distribution shall be completed within three years from the date of this Act, or as soon thereafter as practicable.

(b) The tribe shall designate any part of the tribe's property that is to be set aside for church, park, playground, or cemetery purposes, and the Secretary is authorized to convey such property to trustees or agencies designated by the tribe for that purpose and approved by the Secretary.

(c) Each member may select for homesite purposes and receive title to not to exceed five acres of tribal land that is being used for homesite purposes by such member. The member shall pay the current market value of the homesite selection excluding any improvements or repairs constructed by such member, his wife, children, or ancestor, as determined by the Secretary of the Interior.

(d) All assets of the tribe that are not selected and conveyed to members shall be sold by competitive bid at not less than the current market value, and any member shall have the right to purchase property offered for sale for a price not less than the highest acceptable bid therefor. If more than one member exercises such right, the property shall be sold to the member exercising the right who offers the highest price.

(e) The net proceeds of all sales of tribal property, and all other tribal funds, shall be used to pay, as authorized by the Secretary, any debts of the tribe. The remainder of such proceeds and funds shall be divided equally among the members whose names are on the final roll, or their heirs or legatees. Any debt owed by a member, heir, or legatee to the tribe or to the United States may be set off as authorized by the Secretary against the distributive share of such person. Any member of the tribe who purchases tribal property in accordance with this section may apply on the purchase price his

share of the proceeds of all sales of tribal property, and the Secretary of the Interior shall adopt sales procedures that permit such action.

SEC. 4. (a) The Secretary of the Interior is authorized to partition or to sell the complete interest (including any unrestricted interest) in any land in which an undivided interest is owned by a member of the Ponca Tribe of Native Americans of Nebraska in a trust or restricted status, provided the partition or sale is requested by the owners of a 25 per centum interest in the land, and the partition or sale is made within three years from the date of this Act. Any such sale shall be by competitive bid, except that with the concurrence of the owners of a 25 per centum interest in the land any owner of an interest in the land shall have the right to purchase the land within a reasonable time fixed by the Secretary of the Interior prior to a competitive sale at not less than its current market value. If more than one preference right is exercised, the sale shall be by competitive bid limited to the persons entitled to a preference. If the owners of a 25 per centum interest in the land so request, mineral rights may be reserved to the owners in an unrestricted status. The Secretary of the Interior may represent for the purposes of this section any Indian owner who is a minor, or who is non compos mentis, and, after giving reasonable notice of the proposed partition or sale by publication, he may represent an Indian owner who cannot be located.

(b) All restrictions on the alienation or taxation of interests in land that are owned by members of the Ponca Tribe of Native Americans of Nebraska three years after the date of this Act shall be deemed removed by operation of law, and an unrestricted title shall be vested in each such member.

SEC. 5. The Secretary of the Interior is authorized to make such land surveys and to execute such conveyancing instruments as he deems necessary to convey marketable and recordable title to the individual and tribal assets disposed of pursuant to this Act. Each grantee shall receive an unrestricted title to the property conveyed.

SEC. 6. Nothing in this Act shall affect any claims heretofore filed against the United States by the Ponca Tribe of Native Americans of Nebraska.

SEC. 7. Nothing in this Act shall affect the rights, privileges, or obligations of the tribe and its members under the laws of Nebraska.

SEC. 8. No property distributed under the provisions of this Act shall at the time of distribution be subject to any Federal or State income tax. Following any distribution of property made under the provisions of this Act, such property and income derived therefrom by the distributee shall be subject to the same taxes, State and Federal as in the case of non-Indians: *Provided*, That for the purpose of capital gains or losses the base value of the property shall be the value of the property when distributed to the grantee.

SEC. 9. Such amounts of tribal funds as may be needed to meet the expenses of the tribe under this Act, as approved by the Secretary of the Interior, shall be available for expenditure. There is authorized to be appropriated out of any moneys in the Treasury not otherwise appropriated such sums as may be necessary to reimburse the tribe for

such expenditures, and carry out the responsibilities of the Secretary under the provisions of this Act.

SEC. 10. When the distribution of tribal assets in accordance with the provisions of this Act has been completed, the Secretary of the Interior shall publish in the Federal Register a proclamation declaring that the Federal trust relationship to such tribe and its members has terminated. Thereafter, the tribe and its members shall not be entitled to any of the special services performed by the United States for Indians or Indian tribes because of their Indian status, all statutes of the United States that affect Indians or Indian tribes because of their Indian status shall be inapplicable to them, and the laws of the several States shall apply to them in the same manner they apply to other persons or citizens within their jurisdiction. Nothing in this Act, however, shall affect the status of any Indian as a citizen of the United States.

Approved September 5, 1962.

PUBLIC LAW 87-682
EIGHTY-SEVENTH CONGRESS, SEPTEMBER 25, 1962
H.R. 6413 [6]

An Act to extend to fishermen the same treatment accorded farmers in relation to estimated income tax.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) the following provisions of the Internal Revenue Code of 1954 are amended by inserting "or fishing" after "from farming" each place it appears:

(1) Section 6015(f) (relating to treatment of return as declaration or amendment).

(2) Section 6073(b) (relating to time for filing declarations of estimated income tax by individuals).

(3) Section 6153(b) (relating to installment payments of estimated income tax by individuals who are farmers).

(4) Subsections (b) and (d)(1)(C) of section 6654 (relating to additions to tax for failure by individual to pay estimated income tax).

(b) Section 6073(a) of the Internal Revenue Code of 1954 (relating to time for filing declarations of estimated income tax by individuals other than farmers) is amended by striking out "individuals not regarded as farmers" and inserting in lieu thereof "individuals regarded as neither farmers nor fishermen".

(c) The headings of subsections (a) and (b) of section 6073, and subsection (b) of section 6153, of the Internal Revenue Code of 1954 are each amended by inserting "OR FISHERMEN" after "FARMERS".

SEC. 2. The amendments made by the first section of this Act shall apply only with respect to taxable years beginning December 31, 1962.

Approved September 25, 1962.

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[6] Senate Report No. 1819, page 241, this Bulletin; House Report No. 346 is not published herein.

PUBLIC LAW 87–710
EIGHTY-SEVENTH CONGRESS, SEPTEMBER 27, 1962
H.R. 12526 [7]

An Act to amend section 172 of the Internal Revenue Code of 1954 to provide a seven-year net operating loss carryover for certain regulated transportation corporations.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subsection (b) of section 172 of the Internal Revenue Code of 1954 (relating to net operating loss deduction) is amended to read as follows:

(b) Net Operating Loss Carrybacks and Carryovers.—

(1) Years to which loss may be carried.—A net operating loss for any taxable year—

(A) ending after December 31, 1957, shall be a net operating loss carryback to each of the 3 taxable years preceding the taxable year of the loss, and

(B) ending after December 31, 1955, shall (except as provided in subparagraph (C)) be a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss, or

(C) ending after December 31, 1955, in the case of a taxpayer which is a regulated transportation corporation (as defined in subsection (j) (1)), shall (except as provided in subsection (j)) be a net operating loss carryover to each of the 7 taxable years following the taxable year of such loss.

(2) Amount of carrybacks and carryovers.—Except as provided in subsections (i) and (j), the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the "loss year") shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the taxable income for any such prior taxable years shall be computed—

(A) with the modifications specified in subsection (d) other than paragraphs (1), (4), and (6) thereof; and

(B) by determining the amount of the net operating loss deduction without regard to the net operating loss for the loss year or for any taxable year thereafter,

and the taxable income so computed shall not be considered to be less than zero.

(b) Section 172 of such Code is amended by redesignating subsection (j) as subsection (k) and by inserting after subsection (i) the following new subsection:

(j) Carryover of Net Operating Loss for Certain Regulated Transportation Corporations.—

(1) Definition.—For purposes of subsection (b)(1)(C), the term "regulated transportation corporation" means a corporation—

(A) 80 percent or more of the gross income of which (computed without regard to dividends and capital gains and losses) for the taxable year is derived from the furnishing or sale of transportation described in subparagraph (A), (C)(i), (E), or (F) of section 1503 (c)(1) and taken into account for purposes of section 1503(c)(2),

(B) which is described in section 1503(c)(3), or

(C) which is a member of a regulated transportation system.

[7] Senate Report No. 2041, page 243, this Bulletin; since House Report No. 2252 is substantially the same as the Senate Report, it is not published herein.

(2) REGULATED TRANSPORTATION SYSTEM.—For purposes of this subsection, a corporation shall be treated as a member of a regulated transportation system for a taxable year if—

(A) it is a member of an affiliated group of corporations making a consolidated return for such taxable year, and

(B) 80 percent or more of the aggregate gross income of the members of such affiliated group (computed without regard to dividends and capital gains and losses) for such taxable year is derived from sources described in paragraph (1)(A).

For purposes of subparagraph (B), income derived by a corporation described in section 1503(c)(3) from leases described in subparagraph (A) thereof shall be considered as derived from sources described in paragraph (1)(A).

(3) LIMITATION.—For purposes of subsection (b)(1)(C)—

(A) a net operating loss may not be a net operating loss carryover to the 6th taxable year following the loss year unless the taxpayer is a regulated transportation corporation for such 6th taxable year; and

(B) a net operating loss may not be a net operating loss carryover to the 7th taxable year following the loss year unless the taxpayer is a regulated transportation corporation for the 6th taxable year following the loss year and for such 7th taxable year.

(4) TAXABLE YEARS BEGINNING IN 1955 AND ENDING IN 1956.—In the case of a net operating loss for a taxable year beginning in 1955 and ending in 1956, the amount of such loss which may be carried—

(A) to the 6th taxable year following the loss year shall be the amount which bears the same ratio to the amount which (but for this paragraph) would be carried to such 6th taxable year as the number of days in the loss year after December 31, 1955, bears to the total number of days in the loss year, and

(B) to the 7th taxable year following the loss year shall be the amount (if any) by which (i) the amount carried to the 6th taxable year (determined under subparagraph (A)), exceeds (ii) the taxable income (computed as provided in subsection (b)(2)) for such 6th taxable year.

SEC. 2. The amendments made by the first section of this Act shall apply only with respect to net operating losses for taxable years ending after December 31, 1955.

Approved September 27, 1962.

PUBLIC LAW 87-722
EIGHTY-SEVENTH CONGRESS, SEPTEMBER 28, 1962
H.R. 12577[8]

An Act to place authority over the trust powers of national banks in the Comptroller of the Currency.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) the Comptroller of the Currency shall be authorized and empowered to grant by special permit to national banks applying therefor, when not in contravention of State or local law, the right to act as trustee, executor, administrator, registrar of stocks and bonds, guardian of estates, assignee, receiver, committee of estates of lunatics, or in any other fiduciary capacity in which State banks, trust companies, or other corporations which come into competition with national banks are

[8] This publication of the law is restricted to excerpts involving internal revenue matters; Senate Report No. 2039, page 246, this Bulletin; since House Report No. 2255 is substantially the same as the Senate Report, it is not published herein.

permitted to act under the laws of the State in which the national bank is located.

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SEC. 4. Paragraph (2) of subsection (a) of section 584 of the Internal Revenue Code of 1954 is amended by inserting "or the Comptroller of the Currency" immediately after "the Board of Governors of the Federal Reserve System".

SEC. 5. Section 581 of the Internal Revenue Code of 1954 is amended by striking out "section 11(k) of the Federal Reserve Act (38 Stat. 262; 12 U.S.C. 248(k))", and inserting in lieu thereof "authority of the Comptroller of the Currency".

Approved September 28, 1962.

PUBLIC LAW 87-734
EIGHTY-SEVENTH CONGRESS, OCTOBER 3, 1962
H.R. 5144 [9]

An Act to provide for the acquisition of and the payment for individual Indian and tribal lands of the Lower Brule Sioux Reservation in South Dakota, required by the United States for the Big Bend Dam and Reservoir project on the Missouri River, and for the rehabilitation, social, and economic development of the members of the tribe, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That in furtherance of the Big Bend Dam and Reservoir project authorized by the Flood Control Act of December 22, 1944 (58 Stat. 887, 891)—

(a) The entire interest, including gravel but excluding the interest in oil, gas, and all other minerals of any nature whatsoever, in approximately 14,299.03 acres of land within the taking area described in this Act in the Lower Brule Sioux Reservation in South Dakota, in which the Lower Brule Sioux Tribe or individual Indians have a trust or restricted interest, and any interest the tribe or Indians may have within the bed of the Missouri River so far as it is within the boundaries of the reservation are hereby taken by the United States for the Big Bend Dam and Reservoir project on the Missouri River, and in consideration thereof and for trust or restricted lands heretofore acquired by the United States in condemnation proceedings for the Big Bend project the United States will pay to the tribe and the individual Indian owners, out of funds available for the Big Bend Dam and Reservoir project—

(1) a sum aggregating $825,000, to be disbursed in accordance with the provisions of schedules prepared pursuant to section 2(b) of this Act; and

(2) the amount of $400,715, which shall be in settlement of all claims, rights, and demands of the tribe and individual Indians arising out of the taking under this Act, to be disbursed in accordance with the provisions of section 2 hereof.

(b) Upon a determination by the Secretary of the Army, within two years from the date of enactment of this Act, filed among the

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[9] House Report No. 852 and Senate Report No. 1636 are not published herein.

appropriate land records of the Department of the Interior, that any of the lands described in this Act are not required for Big Bend project purposes, title to such land shall be revested in the former owner.

Sec. 2. (a) The payments authorized by section 1 of this Act, less the amounts heretofore deposited by the United States in the case entitled United States of America, Plaintiff against 867.50 acres of land, etc., and Crow Creek Tribe of Sioux Indians et al., Defendants, civil numbered 335, filed in the United States District Court for the District of South Dakota, for trust property acquired in the taking area described in this Act, shall be deposited to the credit of the tribe in the Treasury of the United States and shall draw interest on the principal at the rate of 4 per centum per annum until expended.

(b) The amount paid pursuant to section 1(a)(1) of this Act shall be allocated in accordance with Indian ownership schedules prepared by the Secretary of the Interior, after consultation with the Lower Brule Tribal Council to correct known errors and to insure fair and equitable allocation. These schedules shall reflect the amount agreed upon by the Secretary of the Army and the Secretary of the Interior as the basis for negotiation, after appropriate acreage adjustments, increased by a uniform percentage to equal the amount paid. The amounts allocated for payment of property owned by individual Indians shall be credited to their respective individual Indian money accounts. No part of the compensation provided for in section 1 shall be subject to any lien, debt, or claim of any nature whatsoever against the tribe or the individual Indian owners entitled to the compensation, except delinquent debts owed to the United States by the tribe, or delinquent debts owned to the tribe or to the United States by the individual Indians entitled to the compensation: *Provided*, That such compensation shall not be applied to the payment of such individual delinquent debts unless the Secretary of the Interior first determines and certifies that no hardship will result from the payment of such delinquent debts.

(c) The tribal council, with the approval of the Secretary of the Interior, shall make available from the funds authorized by section 1(a)(2) of this Act not to exceed $247,325, to pay the expenses, costs, losses, and damages incurred by members of the tribe as a direct result of moving themselves and their possessions, including dwellings and other buildings owned by the individual members, on account of the acquisition referred to in section 1 of this Act. The balance of the amount paid pursuant to section 1(a)(2) shall be consolidated with the appropriation authorized by section 3 of this Act and shall be expended in accordance with the provisions of section 3.

Sec. 3. There is authorized to be appropriated the additional sum of $1,968,750 which shall be deposited in the Treasury of the United States to the credit of the tribe and which shall draw interest on the principal at the rate of 4 percentum per annum until expended, for the purposes of developing individual and family plans, relocating, reestablishing, and providing other assistance designed to improve the economic and social conditions of enrolled members of the tribe on the date of enactment of this Act. The funds authorized by this section shall be expended in accordance with plans and programs

approved by both the tribal council and the Secretary of the Interior: *Provided*, That $400,000 shall be allocated exclusively for industrial development on the reservation or within fifty miles of any exterior boundary of the reservation with preferential right of employment for members of the tribe. Nothing in this Act shall be construed to prevent cooperative action with the Crow Creek Sioux Tribe on industrial development or other programs: *And provided further*, That no part of such funds shall be used for per capita payments, or for the purchase of land by the tribe except for the purpose of resale to individual Indians in furtherance of the rehabilitation program authorized by this section, which resale is hereby authorized.

SEC. 4. The Secretary of the Army, out of funds appropriated for the Big Bend project other than funds provided by this Act, is authorized and directed to relocate and reestablish such Indian cemeteries, tribal monuments, and shrines within the taking area of the Big Bend project as the tribal council, with the approval of the Secretary of the Interior, shall select and designate: *Provided*, That reinterment of individual remains, but not entire cemeteries, outside the reservation boundaries is authorized if desired by the next of kin and approved by the tribal council, but in no event will reinterment be made to a site which exceeds the equivalent distance from the disinterment site to the farthest point at which reinterment could be made within the reservation boundaries.

SEC. 5. The Secretary of the Army is authorized and directed out of funds appropriated for the Big Bend project other than funds provided by this Act to protect, replace, relocate, or reconstruct any existing essential governmental and agency facilities on the reservation, including schools, hospitals, Public Health Service and Bureau of Indian Affairs offices, facilities, service buildings, and employees' quarters, roads, bridges, and incidental matters or facilities in connection therewith, which the Secretary of the Interior determines will be impaired or required by reason of the Big Bend project: *Provided, however*, That the design criteria employed shall be reasonably comparable to that of the presently existing roads, bridges, and facilities.

SEC. 6. The Secretary of the Army, under plans approved by the Secretary of the Interior after consultation with the Lower Brule Tribal Council, is authorized and directed, out of funds appropriated for the Big Bend project other than funds provided by this Act, to locate, lay out, and construct on tribal land on a site provided by the Lower Brule Sioux Council with the approval of the Secretary of the Interior a townsite for the new town of Lower Brule, including substitute and replacement streets, utilities, including water, sewerage, and electricity, taking into account the relocation and replacement of the governmental and agency facilities as provided for in section 5 of this Act and the reasonable future growth of the new town: *Provided, however*, That the design criteria employed shall be reasonably comparable to that of the existing town streets, utilities, and facilities. The tribal council is authorized, with the approval of the Secretary of the Interior (a) to convey, with or without compensation, tribal land, exclusive of minerals, for church or cemetery purposes for so long as the land is used for such purposes, and (b) to sell unimproved lots, exclusive of minerals, in the relocated town of Lower Brule at

competitive sale to the highest qualified bidder but for not less than the appraised value, pursuant to such terms and conditions as the Secretary of the Interior may prescribe.

SEC. 7. All minerals of any kind whatsoever, including oil and gas, but excluding gravel, in the lands taken by this Act are hereby reserved for the benefit of the tribe or individual Indian owners as their interests may appear. All right, title, and interest of the United States in such minerals in trust or restricted land heretofore acquired by the United States for the Big Bend project are hereby revested in the former owners. All such minerals in trust or restricted land hereafter acquired by the United States for the Big Bend project shall be reserved for the benefit of the owners as their interests may appear. Notwithstanding the foregoing provisions of this section the exploration and development of such minerals, including oil and gas, within the taking area shall be subject to all reasonable regulations of the Secretary of the Army necessary for the protection of the Big Bend project.

SEC. 8. Members of the Lower Brule Sioux Tribe now residing within the taking area of the Big Bend project shall have the right without charge to remain on and use the lands taken by this Act until required to vacate at such times as may be fixed by the Secretary of the Army, with the approval of the Secretary of the Interior: *Provided*, That the time for vacating in any event will not extend beyond July 1, 1963.

SEC. 9. Individual Indians and the tribe are authorized without charge to retain timber and improvements removed by them from their respective trust or restricted lands on the reservation acquired by this Act and heretofore acquired by the United States for the Big Bend project. Up to sixty days before the individual Indian landowners and the tribe are required to vacate the taking area in accordance with this Act, they shall have the right, without charge, to cut and remove all timber and to salvage any improvements on their respective lands, but, if such rights are not exercised or are waived within the time prescribed, the tribe, through its tribal council, may exercise such rights: *Provided*, That the timber cut and the salvage permitted by this section shall not be construed to be compensation.

SEC. 10. Subject to the right of the United States to occupy, use, and control trust and restricted lands acquired by this Act and heretofore acquired in condemnation action civil numbered 335 for the construction, operation, and maintenance of the Big Bend Dam and Reservoir project pursuant to the Flood Control Act of 1944, approved December 22, 1944, and amendatory laws, as determined necessary by the Secretary of the Army adequately to serve said purposes, the Lower Brule Sioux Tribe shall be permitted, after the Big Bend Dam gates are closed and the waters of the Missouri River impounded, to graze stock without charge on such of the land described in this section as lies between the level of the reservoir and the taking line described in section 16 of this Act and as the Secretary of the Army determines is not devoted to other beneficial uses and to lease such land for grazing purposes to members or nonmembers of the tribe on such terms and conditions as the Secretary of the Interior may prescribe. The tribe

and members thereof shall have without cost the right of free access to the shoreline of the reservoir including the right to hunt and fish in and on the aforesaid shoreline and reservoir, subject, however, to regulations governing the corresponding use by other citizens of the United States.

SEC. 11. Notwithstanding any other provision of law, for the purposes of (1) providing substitute land for individual Indians who owned land within the taking area of the Fort Randall or Big Bend projects, (2) consolidating landholdings, and (3) eliminating fractionated heirship interests within the reservation, the Secretary of the Interior is authorized to purchase, with funds made available by such individual Indians or by the tribe, land or interests in land, and to sell tribal land upon request of the tribe, but no service charge shall be made by the United States. The land selected by and purchased for individual Indians may be either inside or outside the boundaries of the reservation. Title to any land or interests in land acquired within the boundaries of the reservation shall be taken in the name of the United States in trust for the tribe or the individual Indian for whom the land is acquired, and title to any land or interests in land acquired outside the boundaries of the reservation shall be taken in the name of the individual for whom it is acquired: *Provided*, That title to lands outside the exterior boundaries of the reservation acquired by the tribe shall be taken in the name of the tribe subject to a restriction against alienation without the consent of the Secretary of the Interior, but shall not be exempt from taxation.

For the purposes of this section, the Secretary of the Interior is authorized to partition or sell individually owned lands in which all interests are held in trust or restricted status (1) upon the request of the owners of not less than a 25 per centum interest in such land where ten persons or more own or claim interests in the land, or (2) upon the request of the owners of not less than a 50 per centum interest in such land where fewer than ten persons own or claim interests in the land. For the purpose of this section, the Secretary of the Interior may represent any Indian owner who is a minor or who is under any other legal disability, and the Secretary, after first giving reasonable notice by publication of the proposed sale, is authorized to represent any Indian owner or claimant who cannot be located after reasonable and diligent search. Sales of all Indian trust or restricted interests in land shall be in accordance with the following procedure:

(a) Upon receipt of requests from the required ownership interests, the Secretary shall notify the tribe and each owner of an undivided Indian interest in the land by a letter directed to his last known address that each such owner and the tribe has a right to purchase the land for its appraised value, unless one of the owners objects within the time fixed by the Secretary, or for a lower price if all of the owners agree, and that if more than one owner or if one owner and the tribe wants to purchase the land it will be sold on the basis of sealed competitive bids restricted to the owners of undivided interests in the land and the tribe.

(b) If no Indian owner of an undivided interest in the land elects to purchase the land within the time fixed by the Secretary, and the tribe owns no interest in the land, the Secretary shall offer to sell

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the land at its appraised value to the tribe, unless one of the Indian owners or his authorized representative objects within the time fixed by the Secretary to a sale to the tribe at the appraised value.

(c) If any Indian owner or his authorized representative objects to a sale to the tribe at the appraised value, the Secretary shall offer the land for sale by sealed competitive bid with a preferential right in the tribe or any Indian owner to meet the high bid, unless one of the Indian owners or his authorized representative objects within the time fixed by the Secretary to the grant of such preferential right. All bids shall be rejected if no bid substantially equal to the appraised value is received.

(d) If any Indian owner or his authorized representative objects to a sale by sealed competitive bid with a preferential right to meet the high bid, the Secretary shall offer the land for sale by sealed bids without such preferential right: *Provided*, That, if at any time before sealed bids are invited the tribe or one of the Indian owners asks that the land be sold at auction, then after notice to all interested parties, including the tribe, the land shall be sold at auction immediately after the opening of the sealed bids and auction bidding shall be limited to the Indian owners, the tribe, and persons who submitted sealed bids in amounts not less than 75 per centum of the appraised value of the land. The highest sealed bid shall be considered the opening auction bid. No sale shall be made unless the price is equal to the highest sealed bid and substantially equal to the appraised value.

(e) The Secretary may, when he deems it in the best interests of the Indian owners, obtain a power of attorney from the owner of a non-Indian interest in the land to be sold authorizing the Secretary to sell and convey the interest of the non-Indian owner in accordance with any part of the procedure provided in this section.

Sec. 12. The Secretary of the Treasury, upon certification by the Secretary of the Interior, shall reimburse the tribe for fees and expenses incurred in connection with the taking of Indian lands within the reservation for the Big Bend project: *Provided*, That such reimbursable fees and expenses shall not exceed in the aggregate, $75,000: *Provided further*, That attorney fees shall be paid under the terms of a contract approved by the Secretary of the Interior.

Sec. 13. (a) Any individual Indian who has been duly tendered payment in accordance with the schedules prepared pursuant to section 2(b) of this Act, shall have the right to reject the sum tendered by filing a notice of rejection with the Chief of Engineers, United States Army, Washington, District of Columbia, or with the superintendent of the Pierre Indian Agency, Pierre, South Dakota, within one year from the date of enactment of this Act or within ninety days after the tender is made, whichever date is later. For the purpose of this section, the Secretary of the Interior and the tribe are authorized to represent any Indian entitled to payment who is a minor, or under any other legal disability, or who cannot be located after a reasonable and diligent search, and any person who is an undetermined heir or devisee of a deceased Indian.

(b) If the land of any Indian rejecting payment is included in condemnation proceedings heretofore instituted, the court in those

proceedings shall proceed to determine the just compensation to which the individual is entitled and, if the land is not included in such condemnation proceedings, jurisdiction is hereby conferred upon the United States District Court for the District of South Dakota to determine just compensation in accordance with procedures applicable to the determination of just compensation in condemnation proceedings. No court or statutory costs, but all other costs and expenses, including attorney's fees, shall be at the contesting individual's expense. Suit may be brought on behalf of any individual rejecting payment within one year after the date of the rejection. If a notice of rejection of the tender of payment is filed, at least 10 per centum of the tender deposited in the individual Indian money account shall be withheld from disbursement pending a final determination under this subsection.

SEC. 14. No part of any expenditure made by the United States under any of the provisions of this Act shall be charged by the United States as an offset or counterclaim against any tribal claim against the United States which has arisen prior to the date of enactment of this Act. The payment of Sioux benefits as provided for in section 17 of the Act of March 2, 1889 (25 Stat. 888), as amended, shall be continued under the provisions of section 14 of the Indian Reorganization Act of June 18, 1934 (48 Stat. 984), on the basis now in operation without regard to the loss of tribal land within the taking area for the Big Bend project.

SEC. 15. There is hereby authorized to be appropriated such amounts as may be necessary for the purposes of this Act.

SEC. 16. The land taken by section 1 of this Act, embracing approximately 14,299.03 acres, and the land heretofore acquired in condemnation proceedings by civil numbered 335, embracing approximately 310.00 acres, are the lands identified and delimited on a map entitled, "A map delimiting tribal and individual Indian trust and restricted land of the Lower Brule Sioux Reservation acquired by the United States for the Big Bend Dam and Reservoir project for the sum of $825,000". Legal descriptions of the lands shown therein shall be prepared by the Secretary of the Army and attached thereto. The map and descriptions shall be prepared by the Secretary of the Army and shall be filed among the land records of the Bureau of Indian Affairs in Washington, District of Columbia, and a duplicate original filed and maintained at the agency in Pierre, South Dakota. A true and correct copy of the map and descriptions shall be furnished without cost to the tribe. The Secretary of the Army shall prepare and furnish the Secretary of the Interior and the tribe tract by tract legal descriptions of trust and restricted land acquired by this Act within two years of enactment of this Act: *Provided*, That within ninety days after notice of rejection is filed pursuant to subsection 13(a) the Secretary of the Army shall furnish to the individual Indian and to the Superintendent of the Pierre Indian Agency a legal description of the lands covered by the rejection.

SEC. 17. All funds authorized by this Act paid to the tribe and individual Indians shall be exempt from all forms of State and Federal taxation.

SEC. 18. The Secretary of the Army is authorized and directed to pay to any bona fide lessee or permittee owning improvements situated on Indian tribal land the fair value, as determined by the Secretary, or by a court of competent jurisdiction, of any such improvements which will be rendered inoperative or be otherwise adversely affected by the construction of the Big Bend Dam and Reservoir project.

Approved October 3, 1962.

PUBLIC LAW 87–735
EIGHTY-SEVENTH CONGRESS, OCTOBER 3, 1962
H.R. 5165 [10]

An Act to provide for the acquisition of and the payment for individual Indian and tribal lands of the Crow Creek Sioux Reservation in South Dakota, required by the United States for the Big Bend Dam and Reservoir project on the Missouri River, and for the rehabilitation, social, and economic development of the members of the tribe, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That in furtherance of the Big Bend Dam and Reservoir project authorized by the Flood Control Act of December 22, 1944 (58 Stat. 887, 891)—

(a) The entire interest, including gravel but excluding the interest in oil, gas, and all other minerals of any nature whatsoever, in approximately 6,283.57 acres of land within the taking area described in this Act in the Crow Creek Sioux Reservation in South Dakota, in which the Crow Creek Sioux Tribe or individual Indians have a trust or restricted interest, and any interest the tribe or Indians may have within the bed of the Missouri River so far as it is within the boundaries of the reservation are hereby taken by the United States for the Big Bend Dam and Reservoir project on the Missouri River, and in consideration thereof and for 132.61 acres of trust or restricted lands heretofore acquired by the United States in condemnation proceedings for the Big Bend project the United States will pay to the tribe and the individual Indian owners, out of funds available for the Big Bend Dam and Reservoir project—

(1) a sum aggregating $355,000 to be disbursed in accordance with the provisions of schedules prepared pursuant to section 2(b) of this Act; and

(2) the amount of $209,302, which shall be in settlement of all claims, rights, and demands of the tribe and individual Indians arising out of the taking under this Act, to be disbursed in accordance with the provisions of section 2 hereof.

(b) Upon a determination by the Secretary of the Army, within two years from the date of enactment of this Act, filed among the appropriate land records of the Department of the Interior, that any of the lands described in this Act are not required for Big Bend project purposes, title to such land shall be revested in the former owner.

SEC. 2. (a) The payments authorized by section 1 of this Act, less the amounts heretofore deposited by the United States in the case

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[10] House Report No. 853 and Senate Report No. 1637 are not published herein.

entitled United States of America, Plaintiff, against 867.50 acres of land, etc., and Crow Creek Tribe of Sioux Indians et al., Defendants, civil numbered 335, filed in the United States District Court for the District of South Dakota, for trust property acquired in the taking area described in this Act, shall be deposited to the credit of the tribe in the Treasury of the United States and shall draw interest on the principal at the rate of 4 per centum per annum until expended: *Provided*, That there shall not be deducted from the payments authorized by section 1 of this Act amounts deposited as compensation in the aforesaid case for improvements located on lands not owned by the individual Indian owner of the improvements.

(b) The amount paid pursuant to section 1(a)(1) of this Act shall be allocated in accordance with Indian ownership schedules prepared by the Secretary of the Interior, after consultation with the Crow Creek Tribal Council to correct known errors and to insure fair and equitable allocation. These schedules shall reflect the amount agreed upon by the Secretary of the Army and the Secretary of the Interior as the basis for negotiation, after appropriate acreage adjustments, increased by a uniform percentage to equal the amount paid. The amounts allocated for payment of property owned by individual Indians shall be credited to their respective individual Indian money accounts. No part of the compensation provided for in section 1 shall be subject to any lien, debt, or claim of any nature whatsoever against the tribe or the individual Indian owners entitled to the compensation, except delinquent debts owed to the United States by the tribe, or delinquent debts owed to the tribe or to the United States by the individual Indians entitled to the compensation: *Provided*, That such compensation shall not be applied to the payment of such delinquent debts unless the Secretary of the Interior first determines and certifies that no hardship will result from the payment of such delinquent debts.

(c) The tribal council with the approval of the Secretary of the Interior shall make available from the funds authorized by section 1(a)(2) of this Act not to exceed $77,550, to pay the expenses, costs, losses, and damages incurred by members of the tribe as a direct result of moving themselves and their possessions, including dwellings and other buildings owned by the individual members, on account of the acquisition referred to in section 1 of this Act. The balance of the amount paid pursuant to section 1(a)(2) shall be consolidated with the appropriation authorized by section 3 of this Act and shall be expended in accordance with the provisions of section 3.

Sec. 3. There is authorized to be appropriated the additional sum of $3,802,500 which shall be deposited in the Treasury of the United States to the credit of the tribe and which shall draw interest on the principal at the rate of 4 per centum per annum until expended, for the purposes of developing individual and family plans, relocating, reestablishing, and providing other assistance designed to improve the economic and social conditions of enrolled members of the tribe on the date of enactment of this Act. The funds authorized by this section shall be expended in accordance with plans and programs approved by both the tribal council and the Secretary of the Interior: *Provided*, That $400,000 shall be allocated exclusively for industrial

development on the reservation or within fifty miles of any exterior boundary of the reservation with preferential right of employment for members of the tribe. Nothing in this Act shall be construed to prevent cooperative action with the Lower Brule Sioux Tribe on industrial development or other programs: *And provided further*, That no part of such funds shall be used for per capita payments, or for the purchase of land by the tribe except for the purpose of resale to individual Indians in furtherance of the rehabilitation program authorized by this section, which resale is hereby authorized.

Sec. 4. The Secretary of the Army, out of funds appropriated for the Big Bend project other than funds provided by this Act, is authorized and directed to relocate and reestablish such Indian cemeteries, tribal monuments, and shrines within the taking area of the Big Bend project as the tribal council, with the approval of the Secretary of the Interior, shall select and designate: *Provided*, That reinterment of individual remains, but not entire cemeteries, outside the reservation boundaries is authorized if desired by the next of kin and approved by the tribal council, but in no event will reinterment be made to a site which exceeds the equivalent distance from the disinterment site to the farthest point at which reinterment could be made within the reservation boundaries.

Sec. 5. The Secretary of the Army is authorized and directed out of funds appropriated for the Big Bend project other than funds provided by this Act to protect, replace, relocate, or reconstruct any existing essential governmental and agency facilities on the reservation, including schools, hospitals, Public Health Service and Bureau of Indian Affairs offices, facilities, service buildings, and employees' quarters, roads, bridges, and incidental matters or facilities in connection therewith, which the Secretary of the Interior determines will be impaired or required by reason of the Big Bend project: *Provided, however*, That the design criteria employed shall be reasonably comparable to that of the presently existing roads, bridges, and facilities.

Sec. 6. The Secretary of the Army, under plans approved by the Secretary of the Interior after consultation with the Crow Creek Tribal Council, is authorized and directed out of funds appropriated for the Big Bend project other than funds provided by this Act, to locate and construct on tribal land selected by the Crow Creek Tribal Council with the approval of the Secretary of the Interior, a townsite adequate for fifty homes, including streets, utilities, including water, sewage, and electricity, taking into account the reasonable future growth of the townsite, a community center containing space and facilities for community gatherings, tribal offices, tribal council chamber, Bureau of Indian Affairs and Public Health Service offices and quarters and a combination gymnasium and auditorium: *Provided*, That not to exceed $350,000 shall be withdrawn from funds of the tribe authorized under section 3 of this Act, and transferred to funds available for the Big Bend Dam and Reservoir project upon request of the Secretary of the Army after completion of the work.

The tribal council is authorized with the approval of the Secretary of the Interior (a) to convey, with or without compensation, tribal land, exclusive of minerals, for church or cemetery purposes for so long as the land is used for such purposes, and (b) to sell unimproved lots

in the townsite, exclusive of minerals, at competitive sale to the highest qualified bidder but for not less than the appraised value, pursuant to such terms and conditions as the Secretary may prescribe.

SEC. 7. All minerals of any kind whatsoever, including oil and gas, but excluding gravel, in the lands taken by this Act are hereby reserved for the benefit of the tribe or individual Indian owners as their interests may appear. All right, title, and interest of the United States in such minerals in trust or restricted land heretofore acquired by the United States for the Big Bend project, are hereby revested in the former owners. All such minerals in trust or restricted land hereafter acquired by the United States for the Big Bend project shall be reserved for the benefit of the owners as their interests may appear. Notwithstanding the foregoing provisions of this section the exploration and development of such minerals, including oil and gas, within the taking area shall be subject to all reasonable regulations of the Secretary of the Army necessary for the protection of the Big Bend project.

SEC. 8. Members of the Crow Creek Sioux Tribe now residing within the taking area of the Big Bend project shall have the right without charge to remain on and use the lands taken by this Act until required to vacate at such times as may be fixed by the Secretary of the Army, with the approval of the Secretary of the Interior: *Provided*, That the time for vacating in any event will not extend beyond July 1, 1963.

SEC. 9. Individual Indians and the tribe are authorized without charge to retain timber and improvements removed by them from their respective trust or restricted lands on the reservation acquired by this Act and heretofore acquired by the United States for the Big Bend project. Up to sixty days before the individual Indian landowners and the tribe are required to vacate the taking area in accordance with this Act, they shall have the right, without charge, to cut and remove all timber and to salvage any improvements on their respective lands but, if such rights are not exercised or are waived within the time prescribed, the tribe, through its tribal council, may exercise such rights: *Provided*, That the timber cut and the salvage permitted by this section shall not be construed to be compensation.

SEC. 10. Subject to the right of the United States to occupy, use, and control trust and restricted lands acquired by this Act and heretofore acquired in condemnation action civil numbered 335 for the construction, operation, and maintenance of the Big Bend Dam and Reservoir project pursuant to the Flood Control Act of 1944, approved December 22, 1944, and amendatory laws, as determined necessary by the Secretary of the Army adequately to serve said purposes, the Crow Creek Sioux Tribe shall be permitted, after the Big Bend Dam gates are closed and the waters of the Missouri River impounded, to graze stock without charge on such of the land described in this section as lies between the level of the reservoir and the taking line described in section 16 of this Act and as the Secretary of the Army determines is not devoted to other beneficial uses and to lease such land for grazing purposes to members or nonmembers of the tribe on such terms and conditions as the Secretary of the Interior may prescribe. The tribe

and members thereof shall have without cost the right of free access to the shoreline of the reservoir including the right to hunt and fish in and on the aforesaid shoreline and reservoir, subject, however, to regulations governing the corresponding use by other citizens of the United States.

SEC. 11. Notwithstanding any other provision of law, for the purposes of (1) providing substitute land for individual Indians who owned land within the taking area of the Fort Randall or Big Bend projects, (2) consolidating land holdings, and (3) eliminating fractionated heirship interests within the reservation, the Secretary of the Interior is authorized to purchase, with funds made available by such individual Indians or by the tribe, land or interests in land, and to sell tribal land upon request of the tribe, but no service charge shall be made by the United States. The land selected by and purchased for individual Indians may be either inside or outside the boundaries of the reservation. Title to any land or interests in land acquired within the boundaries of the reservation shall be taken in the name of the United States in trust for the tribe or the individual Indian for whom the land is acquired, and title to any land or interests in land acquired outside the boundaries of the reservation shall be taken in the name of the individual for whom it is acquired: *Provided*, That title to lands outside the exterior boundaries of the reservation acquired by the tribe shall be taken in the name of the tribe subject to a restriction against alienation without the consent of the Secretary of the Interior, but shall not be exempt from taxation.

For the purposes of this section, but without limiting the authority contained in the Act of June 25, 1910 (36 Stat. 855), as amended, the Secretary of the Interior is authorized to partition or sell individually owned lands in which all interests are held in trust or restricted status (1) upon the request of the owners of not less than a 25 per centum interest in such land where ten persons or more own or claim interests in the land, or (2) upon the request of the owners of not less than a 50 per centum interest in such land where fewer than ten persons own or claim interests in the land. For the purpose of this section, the Secretary of the Interior may represent any Indian owner who is a minor or who is under any other legal disability, and the Secretary, after first giving reasonable notice by publication of the proposed sale, is authorized to represent any Indian owner or claimant who cannot be located after reasonable and diligent search. Sales of all Indian trust or restricted interests in land shall be in accordance with the following procedure:

(a) Upon receipt of requests from the required ownership interests, the Secretary shall notify the tribe and each owner of an undivided Indian interest in the land by a letter directed to his last known address that each such owner and the tribe has a right to purchase the land for its appraised value, unless one of the owners objects within the time fixed by the Secretary, or for a lower price if all of the owners agree, and that if more than one owner or if one owner and the tribe wants to purchase the land it will be sold on the basis of sealed competitive bids restricted to the owners of undivided interests in the land and the tribe.

(b) If no Indian owner of an undivided interest in the land elects to purchase the land within the time fixed by the Secretary, and the tribe owns no interest in the land, the Secretary shall offer to sell the land at its appraised value to the tribe, unless one of the Indian owners or his authorized representative objects within the time fixed by the Secretary to a sale to the tribe at the appraised value.

(c) If any Indian owner or his authorized representative objects to a sale to the tribe at the appraised value, the Secretary shall offer the land for sale by sealed competitive bid with a preferential right in the tribe or any Indian owner to meet the high bid, unless one of the Indian owners or his authorized representative objects within the time fixed by the Secretary to the grant of such preferential right. All bids shall be rejected if no bid substantially equal to the appraised value is received.

(d) If any Indian owner or his authorized representative objects to a sale by sealed competitive bid with a preferential right to meet the high bid, the Secretary shall offer the land for sale by sealed bids without such preferential right: *Provided*, That, if at any time before sealed bids are invited the tribe or one of the Indian owners asks that the land be sold at auction, then after notice to all interested parties including the tribe, the land shall be sold at auction immediately after the opening of the sealed bids and auction bidding shall be limited to the Indian owners, the tribe, and persons who submitted sealed bids in amounts not less than 75 per centum of the appraised value of the land. The highest sealed bid shall be considered the opening auction bid. No sale shall be made unless the price is equal to the highest sealed bid and substantially equal to the appraised value.

(e) The Secretary may, when he deems it in the best interests of the Indian owners, obtain a power of attorney from the owner of a non-Indian interest in the land to be sold authorizing the Secretary to sell and convey the interest of the non-Indian owner in accordance with any part of the procedure provided in this section.

Sec. 12. The Secretary of the Treasury, upon certification by the Secretary of the Interior, shall reimburse the tribe for fees and expenses incurred in connection with the taking of Indian lands within the reservation for the Big Bend project: *Provided*, That such reimbursable fees and expenses shall not exceed in the aggregate $75,000: *Provided further*, That attorney fees shall be paid under the terms of a contract approved by the Secretary of the Interior.

Sec. 13. (a) Any individual Indian who has been duly tendered payment in accordance with the schedules prepared pursuant to section 2(b) of this Act, shall have the right to reject the sum tendered by filing a notice of rejection with the Chief of Engineers, United States Army, Washington, District of Columbia, or with the superintendent of the Pierre Indian Agency, Pierre, South Dakota, within one year from the date of enactment of this Act or within ninety days after the tender is made, whichever date is later. For the purpose of this section, the Secretary of the Interior and the tribe are authorized to represent any Indian entitled to payment who is a minor, or under any other legal disability, or who cannot be located after a reasonable and diligent search, and any person who is an undetermined heir or devisee of a deceased Indian.

(b) If the land of any Indian rejecting payment is included in condemnation proceedings heretofore instituted, the court in those proceedings shall proceed to determine the just compensation to which the individual is entitled and, if the land is not included in such condemnation proceedings, jurisdiction is hereby conferred upon the United States District Court for the District of South Dakota to determine just compensation in accordance with procedures applicable to the determination of just compensation in condemnation proceedings. No court or statutory costs but all other costs and expenses including attorney's fees shall be at the contesting individual's expense. Suit may be brought on behalf of any individual rejecting payment within one year after the date of the rejection. If a notice of rejection of the tender of payment is filed, at least 10 per centum of the tender deposited in the individual Indian money account shall be withheld from disbursement pending a final determination under this subsection.

Sec. 14. No part of any expenditure made by the United States under any of the provisions of this Act shall be charged by the United States as an offset or counterclaim against any tribal claim against the United States which has arisen prior to the date of enactment of this Act. The payment of Sioux benefits as provided for in section 17 of the Act of March 2, 1889 (25 Stat. 888), as amended, shall be continued under the provisions of section 14 of the Indian Reorganization Act of June 18, 1934 (48 Stat. 984), on the basis now in operation without regard to the loss of tribal land within the taking area for the Big Bend project.

Sec. 15. There are hereby authorized to be appropriated such amounts as may be necessary for the purposes of this Act.

Sec. 16. The land taken by section 1 of this Act, embracing approximately 6,283.57 acres, and the land heretofore acquired in condemnation proceedings by civil numbered 335, embracing approximately 132.61 acres, are the lands identified and delimited on a map entitled, "A map delimiting tribal and individual Indian trust and restricted land of the Crow Creek Sioux Reservation acquired by the United States for the Big Bend Dam and Reservoir project for the sum of $355,000". Legal descriptions of the lands shown therein shall be prepared by the Secretary of the Army and attached thereto. The map and descriptions shall be prepared by the Secretary of the Army and shall be filed among the land records of the Bureau of Indian Affairs in Washington, District of Columbia, and a duplicate original filed and maintained at the agency in Pierre, South Dakota. A true and correct copy of the map and descriptions shall be furnished without cost to the tribe. The Secretary of the Army shall prepare and furnish the Secretary of the Interior and the tribe tract by tract legal descriptions of trust and restricted land acquired by this Act within two years of enactment of this Act: *Provided*, That within ninety days after notice of rejection is filed pursuant to subsection 13(a) the Secretary of the Army shall furnish to the individual Indian and to the Superintendent of the Pierre Indian Agency a legal description of the lands covered by the rejection.

Sec. 17. All funds authorized by this Act paid to the tribe and individual Indians shall be exempt from all forms of State and Federal taxation.

Sec. 18. The Secretary of the Army is authorized and directed to pay to any bona fide lessee or permittee owning improvements situated on Indian tribal land the fair value, as determined by the Secretary, or by a court of competent jurisdiction, of any such improvements which will be rendered inoperative or be otherwise adversely affected by the construction of the Big Bend Dam and Reservoir project.

Approved October 3, 1962.

PUBLIC LAW 87-768
EIGHTY-SEVENTH CONGRESS, OCTOBER 9, 1962
H.R. 8824 [11]

An Act to modify the application of the personal holding company tax in the case of consumer finance companies.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 542(c)(7) of the Internal Revenue Code of 1954 (relating to exceptions to the term "personal holding company") is amended to read as follows:

(7) a lending company, not otherwise excepted by this subsection, authorized to engage in and actively and regularly engaged in the small loan business (consumer finance business) under one or more State statutes providing for the direct regulations of such business, 80 percent or more of the gross income of which consists of either or both of the following—

(A) lawful interest, discount, or other authorized charges received from loans made to individuals in accordance with the provisions of applicable State law, and

(B) lawful income received from domestic subsidiary corporations (of which stock possessing at least 80 percent of the voting power of all classes of stock and of which at least 80 percent of each class of the nonvoting stock is owned directly by such lending company), which are themselves excepted under this paragraph or paragraph (6), (8), or (9) of this subsection,

if at least 60 percent of the gross income is lawful interest, discount, or other authorized charges received from loans made in accordance with the provisions of such small loan (consumer finance) laws to individuals, each of whose indebtedness to such company did not at any time during the taxable year exceed in principal amount the limit prescribed for small loans by such law (or, if there is no such limit, $1,500), and if the deductions allowed to such company under section 162 (relating to trade or business expenses), other than for compensation for personal services rendered by shareholders (including members of the shareholder's

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[11] Senate Report No. 2047, page 248, this Bulletin; since House Report No. 1811 is substantially the same as the Senate Report, it is not published herein.

family as described in section 544(a)(2)), constitute 15 percent or more of its gross income, and the loans to a person, who is a shareholder in such company during the taxable year by or for whom 10 percent or more in value of its outstanding stock is owned directly or indirectly (including, in the case of an individual, stock owned by the members of his family as defined in section 544(a)(2)), outstanding at any time during such year do not exceed $5,000 in principal amount;".

SEC. 2. The amendment made by the first section of this Act shall apply with respect to taxable years beginning after December 31, 1961.

Approved October 9, 1962.

PUBLIC LAW 87–770
EIGHTY-SEVENTH CONGRESS, OCTOBER 9, 1962
H.R. 6682 [12]

An Act to provide for the exemption of fowling nets from duty, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That paragraph 1725 of the Tariff Act of 1930, as amended (U.S. Code, title 19, sec. 1201, par. 1725), is hereby further amended to read as follows:

PAR. 1725. (a) Nets or finished sections of nets for use in otter trawl fishing, if composed wholly or in chief value of manila.

(b) Nets or sections or parts of nets, finished or unfinished, of whatever material or materials composed, for use in taking wild birds under license issued by an appropriate Federal or State governmental authority.

SEC. 2. (a) Section 4216(f)(4)(C) of the Internal Revenue Code of 1954 (relating to the definition of local advertising) is amended by striking out "or appears in a newspaper" and inserting in lieu thereof ", appears in a newspaper or magazine, or is displayed by means of an outdoor advertising sign or poster".

(b) The amendment made by subsection (a) shall apply with respect to articles sold on or after the first day of the first calendar quarter beginning more than 20 days after the date of the enactment of this Act.

Approved October 9, 1962.

PUBLIC LAW 87–775
EIGHTY-SEVENTH CONGRESS, OCTOBER 9, 1962
H.R. 11590 [13]

An Act to provide for the disposition of judgment funds of the Cherokee Nation or Tribe of Indians of Oklahoma.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the Secretary of the Interior is authorized and directed to distribute per capita to

[12] Senate Report No. 1607, page 254, this Bulletin; Conference Report No. 2412, page 256, this Bulletin; since House Report No. 1258 contains no internal revenue matters, it is not published herein.

[13] House Report No. 2077 and Senate Report No. 2173 are not published herein.

all persons whose names appear on the rolls of the Cherokee Nation, which rolls were closed and made final as of March 4, 1907, pursuant to the Act of April 26, 1906 (34 Stat. 137), and subsequent additions thereto, all funds which were appropriated by the Act of September 30, 1961 (75 Stat. 733), in satisfaction of a judgment that was obtained by the Cherokee Tribe in the Indian Claims Commission against the United States in docket numbered 173, together with the interest accrued thereon, except $1,432,084.17 which by stipulation of the parties has been set aside for the payments of any offsets that are finally determined to be due the United States, and except the amount allowed for attorney fees and expenses.

Sec. 2. (a) Except as provided in subsections (b) and (c) of this section, a share or proportional share payable to a living adult shall be paid directly to such adult; (b) a share payable to a deceased enrollee shall be distributed to his heirs or legatees upon the filing of proof of death and inheritance satisfactory to the Secretary of the Interior, or his authorized representative, whose findings and determinations upon such proof shall be final and conclusive: *Provided*, That proportional shares of deceased heirs amounting to $10 or less shall not be distributed, and no inherited share amounting to $5 or less shall be paid, and the money shall revert to the tribe; (c) a share or proportional share payable to a person under twenty-one years of age or to a person under legal disability shall be paid in accordance with such procedures as the Secretary determines will adequately protect the best interests of such persons.

Sec. 3. (a) All claims for per capita shares, whether by a living enrollee or by the heirs or legatees of a deceased enrollee, shall be filed with the Area Director of the Bureau of Indian Affairs, Muskogee, Oklahoma, not later than three years from the date of approval of this Act. Thereafter, all claims and the right to file same shall be forever barred and the unclaimed shares shall revert to the tribe.

(b) Tribal funds that revert to the tribe pursuant to this Act, including interest and income therefrom, may be advanced or expended for any purpose that is authorized by the principal chief of the Cherokee Nation and approved by the Secretary of the Interior.

Sec. 4. No part of any funds which may be distributed in accordance with the provisions of this Act shall be subject to Federal or State income tax.

Sec. 5. No part of any of the funds which may be so distributed shall be subject to any lien, debt, or claim of any nature whatsoever against the tribe or individual Indians except delinquent debts owed by the tribe to the United States, or owed by individual Indians to the tribe or to the United States.

Sec. 6. Payments made under this Act shall not be held to be "other income and resources", as that term is used in sections 2(a)(10)(A), 402(a)(7), 1002(a)(8), and 1402(a)(8) of the Social Security Act (42 U.S.C. 302(a)(10)(A), 602(a)(7), 1202(a)(8), and 1352(a)(8)).

Sec. 7. All costs incident to making the payments authorized by this Act shall be paid by appropriate withdrawals from the judgment fund and interest on the judgment fund, using the interest fund first.

SEC. 8. The Secretary of the Interior is authorized to prescribe rules and regulations to carry out the provisions of this Act.

Approved October 9, 1962.

PUBLIC LAW 87-790
EIGHTY-SEVENTH CONGRESS, OCTOBER 10, 1962
H.R. 12180 [14]

An Act to extend for a temporary period the existing provisions of law relating to the free importation of personal and household effects brought into the United States under Government orders, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That subsection (b) of the first section of the Act entitled "An Act relating to the free importation of personal and household effects brought into the United States under Government orders, and for other purposes", approved June 30, 1955 (Public Law 126, Eighty-fourth Congress; 69 Stat. 242), as amended, is amended by striking out "July 1, 1962" and inserting in lieu thereof "July 1, 1964".

SEC. 2. (a) Section 201 of the Tariff Act of 1930 (19 U.S.C. 1201) is amended by adding at the end thereof the following new paragraph:

PAR. 1829. Monofilament gill nets for use in fish sampling, under such rules and regulations as the Secretary of the Treasury may prescribe.

(b) The amendment made by subsection (a) shall be effective with respect to articles entered or withdrawn from warehouse for consumption on and after the day following the date of enactment of this Act.

SEC. 3. (a) Section 809(d)(6) of the Internal Revenue Code of 1954 (relating to deduction for group life, accident, and health insurance) is amended—

(1) by striking out "group life insurance contracts and group accident and health insurance contracts" and inserting in lieu thereof "accident and health insurance contracts (other than those to which paragraph (5) applies) and group life insurance contracts"; and

(2) by striking out the heading and inserting in lieu thereof

(6) CERTAIN ACCIDENT AND HEALTH INSURANCE AND GROUP LIFE INSURANCE—

(b) Section 815(c)(2)(C) of such Code (relating to policyholders surplus account) is amended by striking out "group life and group accident and health insurance contracts" and inserting in lieu thereof "accident and health insurance and group life insurance contracts".

(c) The amendments made by this section shall apply to taxable years beginning after December 31, 1962.

Approved October 10, 1962.

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[14] Senate Report No. 1720, page 257, this Bulletin; Conference Report No. 2413, page 258, this Bulletin; since House Report No. 1920 does not contain internal revenue matters, it is not published herein.

PUBLIC LAW 87–792
EIGHTY-SEVENTH CONGRESS, OCTOBER 10, 1962
H.R. 10 [15]

An Act to encourage the establishment of voluntary pension plans by self-employed individuals.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Self-Employed Individuals Tax Retirement Act of 1962".

SEC. 2. QUALIFICATION OF PLANS.

Section 401 of the Internal Revenue Code of 1954 (relating to qualified pension, profit-sharing, and stock bonus plans) is amended—

(1) by adding at the end of paragraph (5) of subsection (a) the following new sentence: "For purposes of this paragraph and paragraph (10), the total compensation of an individual who is an employee within the meaning of subsection (c)(1) means such individual's earned income (as defined in subsection (c)(2)), and the basic or regular rate of compensation of such an individual shall be determined, under regulations prescribed by the Secretary or his delegate, with respect to that portion of his earned income which bears the same ratio to his earned income as the basic or regular compensation of the employees under the plan bears to the total compensation of such employees.";

(2) by adding at the end of subsection (a) the following new paragraphs:

(7) A trust shall not constitute a qualified trust under this section unless the plan of which such trust is a part provides that, upon its termination or upon complete discontinuance of contributions under the plan, the rights of all employees to benefits accrued to the date of such termination or discontinuance, to the extent then funded, or the amounts credited to the employees' accounts are nonforfeitable. This paragraph shall not apply to benefits or contributions which, under provisions of the plan adopted pursuant to regulations prescribed by the Secretary or his delegate to preclude the discrimination prohibited by paragraph (4), may not be used for designated employees in the event of early termination of the plan.

(8) A trust forming part of a pension plan shall not constitute a qualified trust under this section unless the plan provides that forfeitures must not be applied to increase the benefits any employee would otherwise receive under the plan.

(9) In the case of a plan which provides contributions or benefits for employees some or all of whom are employees within the meaning of subsection (c)(1), a trust forming part of such plan shall not constitute a qualified trust under this section unless, under the plan, the entire interest of each employee—

(A) either will be distributed to him not later than his taxable year in which he attains the age of 70½ years, or, in the case of an employee other than an owner-employee (as defined in subsection (c)(3)), in which he retires, whichever is the later, or

(B) will be distributed, commencing not later than such taxable year, (i) in accordance with regulations prescribed by the Secretary or his delegate, over the life of such employee or over the lives of such employee and his spouse, or (ii) in accordance with such regulations, over a period not extending beyond the life expectancy of such employee or the life expectancy of such employee and his spouse.

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[15] House Report No. 378, page 261, this Bulletin; Senate Report No. 992, page 303, this Bulletin; and Conference Report No. 2411, page 367, this Bulletin.

A trust shall not be disqualified under this paragraph by reason of distributions under a designation, prior to the date of the enactment of this paragraph, by any employee under the plan of which such trust is a part, of a method of distribution which does not meet the terms of the preceding sentence.

(10) In the case of a plan which provides contributions or benefits for employees some or all of whom are owner-employees (as defined in subsection (c)(3))—

(A) paragraph (3) and the first and second sentences of paragraph (5) shall not apply, but—

(i) such plan shall not be considered discriminatory within the meaning of paragraph (4) merely because the contributions or benefits of or on behalf of employees under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of such employees, and

(ii) such plan shall not be considered discriminatory within the meaning of paragraph (4) solely because under the plan contributions described in subsection (e)(3)(A) which are in excess of the amounts which may be deducted under section 404 (determined without regard to section 404(a)(10)) for the taxable year may be made on behalf of any owner-employee; and

(B) a trust forming a part of such plan shall constitute a qualified trust under this section only if the requirements in subsection (d) are also met.; and

(3) by redesignating subsection (c) as subsection (h) and inserting after subsection (b) the following new subsections:

(c) Definitions and Rules Relating to Self-Employed Individuals and Owner-Employees.—For purposes of this section—

(1) Employee.—The term "employee" includes, for any taxable year, an individual who has earned income (as defined in paragraph (2)) for the taxable year. To the extent provided in regulations prescribed by the Secretary or his delegate, such term also includes, for any taxable year—

(A) an individual who would be an employee within the meaning of the preceding sentence but for the fact that the trade or business carried on by such individual did not have net profits for the taxable year, and

(B) an individual who has been an employee within the meaning of the preceding sentence for any prior taxable year.

(2) Earned income.—

(A) In general.—The term "earned income" means the net earnings from self-employment (as defined in section 1402(a)) to the extent that such net earnings constitute earned income (as defined in section 911(b) but determined with the application of subparagraph (B)), but such net earnings shall be determined—

(i) without regard to paragraphs (4) and (5) of section 1402(c),

(ii) in the case of any individual who is treated as an employee under sections 3121(d)(3)(A), (C), or (D), without regard to paragraph (2) of section 1402(c), and

(iii) without regard to items which are not included in gross income for purposes of this chapter, and the deductions properly allocable to or chargeable against such items.

For purposes of this subparagraph, sections 911(b) and 1402, as in effect for a taxable year ending on December 31, 1962, and subparagraph (B), as in effect for a taxable year beginning on January 1, 1963, shall be treated as having been in effect for all taxable years ending before such date.

(B) Earned income when both personal services and capital are material income-producing factors.—In applying section 911(b) for purposes of subparagraph (A), in the case of an individual who is an employee within the meaning of paragraph (1) and who is engaged in a trade or business in which both personal services and capital are material income-producing factors and with respect to which the individual actually renders personal services on a full-time, or substantially full-time, basis, so much of his share of the net profits of such trade or business as does not exceed $2,500 shall be considered as earned income. In the case of any such individual who is engaged in more than one

trade or business with respect to which he actually renders substantial personal services, if with respect to all such trades or businesses he actually renders personal services on a full-time, or substantially full-time, basis, there shall be considered as earned income with respect to the trades or businesses in which both personal services and capital are material income-producing factors—

(i) so much of his share of the net profits of such trades or businesses as does not exceed $2,500, reduced by

(ii) his share of the net profits of any trade or business in which only personal services is a material income-producing factor.

The preceding sentences shall not be construed to reduce the share of net profits of any trade or business which under the second sentence of section 911(b) would be considered as earned income of any such individual.

(3) Owner-employee.—The term "owner-employee" means an employee who—

(A) owns the entire interest in an unincorporated trade or business, or

(B) in the case of a partnership, is a partner who owns more than 10 percent of either the capital interest or the profits interest in such partnership.

To the extent provided in regulations prescribed by the Secretary or his delegate, such term also means an individual who has been an owner-employee within the meaning of the preceding sentence.

(4) Employer.—An individual who owns the entire interest in an unincorporated trade or business shall be treated as his own employer. A partnership shall be treated as the employer of each partner who is an employee within the meaning of paragraph (1).

(5) Contributions on behalf of owner-employees.—The term "contribution on behalf of an owner-employee" includes, except as the context otherwise requires, a contribution under a plan—

(A) by the employer for an owner-employee, and

(B) by an owner-employee as an employee.

(d) Additional Requirements for Qualification of Trusts and Plans Benefiting Owner-Employees.—A trust forming part of a pension or profit-sharing plan which provides contributions or benefits for employees some or all of whom are owner-employees shall constitute a qualified trust under this section only if, in addition to meeting the requirements of subsection (a), the following requirements of this subsection are met by the trust and by the plan of which such trust is a part:

(1) In the case of a trust which is created on or after the date of the enactment of this subsection, or which was created before such date but is not exempt from tax under section 501(a) as an organization described in subsection (a) on the day before such date, the trustee is a bank, but a person (including the employer) other than a bank may be granted, under the trust instrument, the power to control the investment of the trust funds either by directing investments (including reinvestments, disposals, and exchanges) or by disapproving proposed investments (including reinvestments, disposals, and exchanges). This paragraph shall not apply to a trust created or organized outside the United States before the date of the enactment of this subsection if, under section 402(c), it is treated as exempt from tax under section 501(a) on the day before such date; or, to the extent provided under regulations prescribed by the Secretary or his delegate, to a trust which uses annuity, endowment, or life insurance contracts of a life insurance company exclusively to fund the benefits prescribed by the trust, if the life insurance company supplies annually such information about trust transactions affecting owner-employees as the Secretary or his delegate shall by forms or regulations prescribe. For purposes of this paragraph, the term "bank" means a bank as defined in section 581, a corporation which under the laws of the State of its incorporation is subject to supervision and examination by the commissioner of banking or other officer of such State in charge of the administration of the banking laws of such State, and, in the case of a trust created or organized outside the United States, a bank or trust company, wherever incorporated, exercising fiduciary powers and subject to supervision and examination by governmental authority.

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(2) Under the plan—

(A) the employees' rights to or derived from the contributions under the plan are nonforfeitable at the time the contributions are paid to or under the plan; and

(B) in the case of a profit-sharing plant, there is a definite formula for determining the contributions to be made by the employer on behalf of employees (other than owner-employees).

Subparagraph (A) shall not apply to contributions which, under provisions of the plan adopted pursuant to regulations prescribed by the Secretary or his delegate to preclude the discrimination prohibited by subsection (a)(4), may not be used to provide benefits for designated employees in the event of early termination of the plan.

(3) The plan benefits each employee having a period of employment of 3 years or more. For purposes of the preceding sentence, the term "employee" does not include any employee whose customary employment is for not more than 20 hours in any one week or is for not more than 5 months in any calendar year.

(4) Under the plan—

(A) contributions or benefits are not provided for any owner-employee unless such owner-employee has consented to being included under the plan; and

(B) no benefits may be paid to any owner-employee, except in the case of his becoming disabled (within the meaning of section 213(g)(3)), prior to his attaining the age of 59½ years.

(5) The plan does not permit—

(A) contributions to be made by the employer on behalf of any owner-employee in excess of the amounts which may be deducted under section 404 (determined without regard to section 404(a)(10) for the taxable year;

(B) in the case of a plan which provides contributions or benefits only for owner-employees, contributions to be made on behalf of any owner-employee in excess of the amounts which may be deducted under section 404 (determined without regard to section 404(a)(10)) for the taxable year; and

(C) if a distribution under the plan is made to any employee and if any portion of such distribution is an amount described in section 72(m)(5)(A)(i), contributions to be made on behalf of such employee for the 5 taxable years succeeding the taxable year in which such distribution is made.

Subparagraphs (A) and (B) shall not apply to any contribution which is not considered to be an excess contribution (as defined in subsection (e)(1)) by reason of the application of subsection (e)(3).

(6) Except as provided in this paragraph, the plan meets the requirements of subsection (a)(4) without taking into account for any purpose contributions or benefits under chapter 2 (relating to tax on self-employment income), chapter 21 (relating to Federal Insurance Contributions Act), title II of the Social Security Act, as amended, or any other Federal or State law. If—

(A) of the contributions deductible under section 404 (determined without regard to section 404(a)(10)), not more than one-third is deductible by reason of contributions by the employer on behalf of owner-employees, and

(B) taxes paid by the owner-employees under chapter 2 (relating to tax on self-employment income), and the taxes which would be payable under such chapter 2 by the owner-employees but for paragraphs (4) and (5) of section 1402(c), are taken into account as contributions by the employer on behalf of such owner-employees,

then taxes paid under section 3111 (relating to tax on employers) with respect to an employee may, for purposes of subsection (a)(4), be taken into account as contributions by the employer for such employee under the plan.

(7) Under the plan, if an owner-employee dies before his entire interest has been distributed to him, or if distribution has been commenced in accordance with subsection (a)(9)(B) to his surviving spouse and such surviving spouse dies before his entire interest has been distributed to such surviving spouse, his entire interest (or the remaining part of such interest

if distribution thereof has commenced) will, within 5 years after his death (or the death of his surviving spouse), be distributed, or applied to the purchase of an immediate annuity for his beneficiary or beneficiaries (or the beneficiary or beneficiaries of his surviving spouse) which will be payable for the life of such beneficiary or beneficiaries (or for a term certain not extending beyond the life expectancy of such beneficiary or beneficiaries) and which will be immediately distributed to such beneficiary or beneficiaries. The preceding sentence shall not apply if distribution of the interest of an owner-employee has commenced and such distribution is for a term certain over a period permitted under subsection (a) (9) (B) (ii).

(8) Under the plan—

(A) any contribution which is an excess contribution, together with the income attributable to such excess contribution, is (unless subsection (e) (2) (E) applies) to be repaid to the owner-employee on whose behalf such excess contribution is made;

(B) if for any taxable year the plan does not, by reason of subsection (e) (2) (A), meet (for the purposes of section 404) the requirements of this subsection with respect to an owner-employee, the income for the taxable year attributable to the interest of such owner-employee under the plan is to be paid to such owner-employee; and

(C) the entire interest of an owner-employee is to be repaid to him when required by the provisions of subsection (e) (2) (E).

(9) (A) If the plan provides contributions or benefits for an owner-employee who controls, or for two or more owner-employees who together control, the trade or business with respect to which the plan is established and who also control as an owner-employee or as owner-employees one or more other trades or businesses, such plan and the plans established with respect to such other trades or businesses, when coalesced, constitute a single plan which meets the requirements of subsection (a) (including paragraph (10) thereof) and of this subsection with respect to the employees of all such trades or businesses (including the trade or business with respect to which the plan intended to qualify under this section is established).

(B) For purposes of subparagraph (A), an owner-employee, or two or more owner-employees, shall be considered to control a trade or business if such owner-employee, or such two or more owner-employees together—

(i) own the entire interest in an unincorporated trade or business, or

(ii) in the case of a partnership, own more than 50 percent of either the capital interest or the profits interest in such partnership.

For purposes of the preceding sentence, an owner-employee, or two or more owner-employees, shall be treated as owning any interest in a partnership which is owned, directly or indirectly, by a partnership which such owner-employee, or such two or more owner-employees, are considered to control within the meaning of the preceding sentence.

(10) The plan does not provide contributions or benefits for any owner-employee who controls (within the meaning of paragraph (9) (B)), or for two or more owner-employees who together control, as an owner-employee or as owner-employees, any other trade or business, unless the employees of each trade or business which such owner-employee or such owner-employees control are included under a plan which meets the requirements of subsection (a) (including paragraph (10) thereof) and of this subsection, and provides contributions and benefits for employees which are not less favorable than contributions and benefits provided for owner-employees under the plan.

(11) Under the plan, contributions on behalf of any owner-employee may be made only with respect to the earned income of such owner-employee which is derived from the trade or business with respect to which such plan is established.

(e) Excess Contributions on Behalf of Owner-Employees.—

(1) Excess contribution defined.—For purposes of this section, the term "excess contribution" means, except as provided in paragraph (3)—

(A) if, in the taxable year, contributions are made under the plan only on behalf of owner-employees, the amount of any contribution made on behalf of any owner-employee which (without regard to this

subsection) is not deductible under section 404 (determined without regard to section 404(a)(10)) for the taxable year; or

(B) if, in the taxable year, contributions are made under the plan on behalf of employees other than owner-employees—

(i) the amount of any contribution made by the employer on behalf of any owner-employee which (without regard to this subsection) is not deductible under section 404 (determined without regard to section 404(a)(10)) for the taxable year;

(ii) the amount of any contribution made by any owner-employee (as an employee) at a rate which exceeds the rate of contributions permitted to be made by employees other than owner-employees;

(iii) the amount of any contribution made by any owner-employee (as an employee) which exceeds the lesser of $2,500 or 10 percent of the earned income for such taxable year derived by such owner-employee from the trade or business with respect to which the plan is established; and

(iv) in the case of any individual on whose behalf contributions are made under more than one plan as an owner-employee, the amount of any contribution made by such owner-employee (as an employee) under all such plans which exceeds $2,500; and

(C) the amount of any contribution made on behalf of an owner-employee in any taxable year for which, under paragraph (2) (A) or (E), the plan does not (for purposes of section 404) meet the requirements of subsection (d) with respect to such owner-employee.

For purposes of this subsection, the amount of any contribution which is allocable (determined in accordance with regulations prescribed by the Secretary or his delegate) to the purchase of life, accident, health, or other insurance shall not be taken into account.

(2) Effect of excess contribution.—

(A) In general.—If an excess contribution (other than an excess contribution to which subparagraph (E) applies) is made on behalf of an owner-employee in any taxable year, the plan with respect to which such excess contribution is made shall, except as provided in subparagraphs (C) and (D), be considered, for purposes of section 404, as not meeting the requirements of subsection (d) with respect to such owner-employee for the taxable year and for all succeeding taxable years.

(B) Inclusion of amounts in gross income of owner-employees.—For any taxable year for which any plan does not meet the requirements of subsection (d) with respect to an owner-employee by reason of subparagraph (A), the gross income of such owner-employee shall, for purposes of this chapter, include the amount of net income for such taxable year attributable to the interest of such owner-employee under such plan.

(C) Repayment within prescribed period.—Subparagraph (A) shall not apply to an excess contribution with respect to any taxable year, if, on or before the close of the 6-month period beginning on the day on which the Secretary or his delegate sends notice (by certified or registered mail) to the person to whom such excess contribution was paid of the amount of such excess contribution, the amount of such excess contribution, and the net income attributable thereto, is repaid to the owner-employee on whose behalf such excess contribution was made. If the excess contribution is an excess contribution as defined in paragraph (1)(A) or (B)(i), or is an excess contribution as defined in paragraph (1)(C) with respect to which a deduction has been claimed under section 404, the notice required by the preceding sentence shall not be mailed prior to the time that the amount of the tax under this chapter of such owner-employee for the taxable year in which such excess contribution was made has been finally determined.

(D) Repayment after prescribed period.—If an excess contribution, together with the net income attributable thereto, is not repaid within the 6-month period referred to in subparagraph (C), subparagraph (A) shall not apply to an excess contribution with respect to any taxable year beginning with the taxable year in which the person to whom such excess contribution was paid repays the amount of such excess contribution to the owner-employee on whose behalf such excess contribution

was made, and pays to such owner-employee the amount of net income attributable to the interest of such owner-employee which, under subparagraph (B), has been included in the gross income of such owner-employee for any prior taxable year.

(E) SPECIAL RULE IF EXCESS CONTRIBUTION WAS WILLFULLY MADE.—If an excess contribution made on behalf of an owner-employee is determined to have been willfully made, then—

(i) subparagraphs (A), (B), (C), and (D) shall not apply with respect to such excess contribution;

(ii) there shall be distributed to the owner-employee on whose behalf such excess contribution was willfully made his entire interest in all plans with respect to which he is an owner-employee; and

(iii) no plan shall, for purposes of section 404, be considered as meeting the requirements of subsection (d) with respect to such owner-employee for the taxable year in which it is determined that such excess contribution was willfully made and for the 5 taxable years following such taxable year.

(F) STATUTE OF LIMITATIONS.—In any case in which subparagraph (A) applies, the period for assessing any deficiency arising by reason of—

(i) the disallowance of any deduction under section 404 on account of a plan not meeting the requirements of subsection (d) with respect to the owner-employee on whose behalf an excess contribution was made, or

(ii) the inclusion, under subparagraph (B), in gross income of such owner-employee of income attributable to the interest of such owner-employee under a plan,

for the taxable year in which such excess contribution was made or for any succeeding taxable year shall not expire prior to one year after the close of the 6-month period referred to in subparagraph (C).

(3) CONTRIBUTIONS FOR PREMIUMS ON ANNUITY, ETC., CONTRACTS.—A contribution by the employer on behalf of an owner-employee shall not be considered to be an excess contribution within the meaning of paragraph (1), if—

(A) under the plan such contribution is required to be applied (directly or through a trustee) to pay premiums or other consideration for one or more annuity, endowment, or life insurance contracts on the life of such owner-employee issued under the plan.

(B) the amount of such contribution exceeds the amount deductible under section 404 (determined without regard to section 404(a)(10)) with respect to contributions made by the employer on behalf of such owner-employee under the plan, and

(C) the amount of such contribution does not exceed the average of the amounts which were deductible under section 404 (determined without regard to section 404(a)(10)) with respect to contributions made by the employer on behalf of such owner-employee under the plan (or which would have been deductible under such section if such section had been in effect) for the first 3 taxable years (i) preceding the year in which the last such annuity, endowment, or life insurance contract was issued under the plan and (ii) in which such owner-employee derived earned income from the trade or business with respect to which the plan is established, or for so many of such taxable years as such owner-employee was engaged in such trade or business and derived earned income therefrom.

In the case of any individual on whose behalf contributions described in subparagraph (A) are made under more than one plan as an owner-employee during any taxable year, the preceding sentence shall not apply if the amount of such contributions under all such plans for such taxable year exceed $2,500. Any contribution which is not considered to be an excess contribution by reason of the application of this paragraph shall, for purposes of subparagraphs (B) (ii), (iii), and (iv) of paragraph (1), be taken into account as a contribution made by such owner-employee as an employee to the extent that the amount of such contribution is not deductible under section 404 (determined without regard to section 404(a)

(10)) for the taxable year, but only for the purpose of applying such subparagraphs to other contributions made by such owner-employee as an employee.

(f) CERTAIN CUSTODIAL ACCOUNTS.—

(1) TREATMENT AS QUALIFIED TRUST.—For purposes of this title, a custodial account shall be treated as a qualified trust under this section, if—

(A) such custodial account would, except for the fact that it is not a trust, constitute a qualified trust under this section;

(B) the custodian is a bank (as defined in subsection (d)(1));

(C) the investment of the funds in such account (including all earnings) is to be made—

(i) solely in regulated investment company stock with respect to which an employee is the beneficial owner, or

(ii) solely in annuity, endowment, or life insurance contracts issued by an insurance company;

(D) the shareholder of record of any such stock described in subparagraph (C)(i) is the custodian or its nominee; and

(E) the contracts described in subparagraph (C)(ii) are held by the custodian until distributed under the plan.

For purposes of this title, in the case of a custodial account treated as a qualified trust under this section by reason of the preceding sentence, the custodian of such account shall be treated as the trustee thereof.

(2) DEFINITION.—For purposes of paragraph (1), the term "regulated investment company" means a domestic corporation which—

(A) is a regulated investment company within the meaning of section 851(a), and

(B) issues only redeemable stock.

(g) ANNUITY DEFINED.—For purposes of this section and sections 402, 403, and 404, the term "annuity" includes a face-amount certificate, as defined in section 2(a)(15) of the Investment Company Act of 1940 (15 U.S.C., sec. 80a–2); but does not include any contract or certificate issued after December 31, 1962, which is transferable, if any person other than the trustee of a trust described in section 401(a) which is exempt from tax under section 501(a) is the owner of such contract or certificate.

SEC. 3. DEDUCTIBILITY OF CONTRIBUTIONS TO PLANS.

(a) INCLUSION OF SELF-EMPLOYED INDIVIDUALS.—Section 404(a) of the Internal Revenue Code of 1954 (relating to the deductibility of contributions to pension, annuity, profit-sharing, or stock bonus plans or plans of deferred compensation) is amended—

(1) by striking out in paragraph (2) "and (6)," and inserting in lieu thereof "(6), (7), and (8), and, if applicable, the requirements of section 401(a) (9) and (10) and of section 401(d) (other than paragraph (1),"; and

(2) by adding after paragraph (7) the following new paragraphs:

(8) SELF-EMPLOYED INDIVIDUALS.—In the case of a plan included in paragraph (1), (2), or (3) which provides contributions or benefits for employees some or all of whom are employees within the meaning of section 401(c)(1), for purposes of this section—

(A) the term "employee" includes an individual who is an employee within the meaning of section 401(c)(1), and the employer of such individual is the person treated as his employer under section 401(c)(4);

(B) the term "earned income" has the meaning assigned to it by section 401(c)(2);

(C) the contributions to such plan on behalf of an individual who is an employee within the meaning of section 401(c)(1) shall be considered to satisfy the conditions of section 162 or 212 to the extent that such contributions do not exceed the earned income of such individual derived from the trade or business with respect to which such plan is established, and to the extent that such contributions are not allocable (determined in accordance with regulations prescribed by the Secre-

tary or his delegate) to the purchase of life, accident, health, or other insurance; and

(D) any reference to compensation shall, in the case of an individual who is an employee within the meaning of section 401(c)(1), be considered to be a reference to the earned income of such individual derived from the trade or business with respect to which the plan is established.

(9) PLANS BENEFITING SELF-EMPLOYED INDIVIDUALS.—In the case of a plan included in paragraph (1), (2), or (3) which provides contributions or benefits for employees some or all of whom are employees within the meaning of section 401(c)(1)—

(A) the limitations provided by paragraphs (1), (2), (3), and (7) on the amounts deductible for any taxable year shall be computed, with respect to contributions on behalf of employees (other than employees within the meaning of section 401(c)(1)), as if such employees were the only employees for whom contributions and benefits are provided under the plan;

(B) the limitations provided by paragraphs (1), (2), (3), and (7) on the amounts deductible for any taxable year shall be computed, with respect to contributions on behalf of employees within the meaning of section 401(c)(1)—

(i) as if such employees were the only employees for whom contributions and benefits are provided under the plan, and

(ii) without regard to paragraph (1)(D), the second and third sentences of paragraph (3), and the second sentence of paragraph (7); and

(C) the amounts deductible under paragraphs (1), (2), (3), and (7), with respect to contributions on behalf of any employee within the meaning of section 401(c)(1), shall not exceed the applicable limitation provided in subsection (e).

(10) SPECIAL LIMITATION ON AMOUNT ALLOWED AS DEDUCTION FOR SELF-EMPLOYED INDIVIDUALS.—Notwithstanding any other provision of this section, the amount allowable as a deduction under paragraphs (1), (2), (3), and (7) in any taxable year with respect to contributions made on behalf of an individual who is an employee within the meaning of section 401(c)(1) shall be an amount equal to one-half of the contributions made on behalf of such individual in such taxable year which are deductible under such paragraphs (determined with the application of paragraph (9) and of subsection (e) but without regard to this paragraph). For purposes of section 401, the amount which may be deducted, or the amount deductible, under this section with respect to contributions made on behalf of such individual shall be determined without regard to the preceding sentence.

(b) LIMITATIONS ON DEDUCTIBLE CONTRIBUTIONS ON BEHALF OF SELF-EMPLOYED INDIVIDUALS.—Section 404 of the Internal Revenue Code of 1954 (relating to the deductibility of contributions to pension, annuity, profit-sharing, or stock bonus plans or plans of deferred compensation) is amended by adding after subsection (d) the following new subsections:

(e) SPECIAL LIMITATIONS FOR SELF-EMPLOYED INDIVIDUALS.—

(1) IN GENERAL.—In the case of a plan included in subsection (a)(1), (2), or (3), which provides contributions or benefits for employees some or all of whom are employees within the meaning of section 401(c)(1), the amounts deductible under subsection (a) (determined without regard to paragraph (10) thereof) in any taxable year with respect to contributions on behalf of any employee within the meaning of section 401(c)(1) shall, subject to the provisions of paragraph (2), not exceed $2,500, or 10 percent of the earned income derived by such employee from the trade or business with respect to which the plan is established, whichever is the lesser.

(2) CONTRIBUTIONS MADE UNDER MORE THAN ONE PLAN.—

(A) OVERALL LIMITATION.—In any taxable year in which amounts are deductible with respect to contributions under two or more plans on behalf of an individual who is an employee within the meaning of sec-

tion 401(c)(1) with respect to such plans, the aggregate amount deductible for such taxable year under all such plans with respect to contributions on behalf of such employee (determined without regard to subsection (a)(10)) shall not exceed $2,500, or 10 percent of the earned income derived by such employee from the trades or businesses with respect to which the plans are established, whichever is the lesser.

(B) ALLOCATION OF AMOUNTS DEDUCTIBLE.—In any case in which the amounts deductible under subsection (a) (with the application of the limitations of this subsection) with respect to contributions made on behalf of an employee within the meaning of section 401(c)(1) under two or more plans are, by reason of subparagraph (A), less than the amounts deductible under such subsection determined without regard to such subparagraph, the amount deductible under subsection (a) (determined without regard to paragraph (10) thereof) with respect to such contributions under each such plan shall be determined in accordance with regulations prescribed by the Secretary or his delegate.

(3) CONTRIBUTIONS ALLOCABLE TO INSURANCE PROTECTION.—For purposes of this subsection, contributions which are allocable (determined under regulations prescribed by the Secretary or his delegate) to the purchase of life. accident, health, or other insurance shall not be taken into account.

(f) CERTAIN LOAN REPAYMENTS CONSIDERED AS CONTRIBUTIONS.—For purposes of this section, any amount paid, directly or indirectly, by an owner-employee (within the meaning of section 401(c)(3)) in repayment of any loan which under section 72(m)(4)(B) was treated as an amount received under a contract purchased by a trust described in section 401(a) which is exempt from tax under section 501(a) or purchased as a part of a plan described in section 403(a) shall be treated as a contribution to which this section applies on behalf of such owner-employee to such trust or to or under such plan.

SEC. 4. TAXABILITY OF DISTRIBUTIONS.

(a) EMPLOYEES' ANNUITIES.—Section 72(d)(2) of the Internal Revenue Code of 1954 (relating to employees' annuities) is amended to read as follows:

(2) SPECIAL RULES FOR APPLICATION OF PARAGRAPH (1).—For purposes of paragraph (1)—

(A) if the employee died before any amount was received as an annuity under the contract, the words "receivable by the employee" shall be read as "receivable by a beneficiary of the employee"; and

(B) any contribution made with respect to the contract while the employee is an employee within the meaning of section 401(c)(1) which is not allowed as a deduction under section 404 shall be treated as consideration for the contract contributed by the employee.

(b) SPECIAL RULES RELATING TO SELF-EMPLOYED INDIVIDUALS AND OWNER-EMPLOYEES.—Section 72 of the Internal Revenue Code of 1954 (relating to annuities, etc.) is amended by redesignating subsection (m) as subsection (o) and by inserting after subsection (l) the following new subsections:

(m) SPECIAL RULES APPLICABLE TO EMPLOYEE ANNUITIES AND DISTRIBUTIONS UNDER EMPLOYEE PLANS.—

(1) CERTAIN AMOUNTS RECEIVED BEFORE ANNUITY STARTING DATE.—Any amounts received under an annuity, endowment, or life insurance contract before the annuity starting date which are not received as an annuity (within the meaning of subsection (e)(2)) shall be included in the recipient's gross income for the taxable year in which received to the extent that—

(A) such amounts, plus all amounts theretofore received under the contract and includible in gross income under this paragraph, do not exceed

(B) the aggregate premiums or other consideration paid for the contract while the employee was an owner-employee which were allowed as deductions under section 404 for the taxable year and all prior taxable years.

Any such amounts so received which are not includible in gross income under this paragraph shall be subject to the provisions of subsection (e).

(2) Computation of consideration paid by the employee.—In computing—

(A) the aggregate amount of premiums or other consideration paid for the contract for purposes of subsection (c)(1)(A) (relating to the investment in the contract),

(B) the consideration for the contract contributed by the employee for purposes of subsection (d)(1) (relating to employee's contributions recoverable in 3 years), and

(C) the aggregate premiums or other consideration paid for purposes of subsection (e)(1)(B) (relating to certain amounts not received as an annuity),

any amount allowed as a deduction with respect to the contract under section 404 which was paid while the employee was an employee within the meaning of section 401(c)(1) shall be treated as consideration contributed by the employer, and there shall not be taken into account any portion of the premiums or other consideration for the contract paid while the employee was an owner-employee which is properly allocable (as determined under regulations prescribed by the Secretary or his delegate) to the cost of life, accident, health, or other insurance.

(3) Life insurance contracts.—

(A) This paragraph shall apply to any life insurance contract—

(i) purchased as a part of a plan described in section 403(a), or

(ii) purchased by a trust described in section 401(a) which is exempt from tax under section 501(a) if the proceeds of such contract are payable directly or indirectly to a participant in such trust or to a beneficiary of such participant.

(B) Any contribution to a plan described in subparagraph (A)(i) or a trust described in subparagraph (A)(ii) which is allowed as a deduction under section 404, and any income of a trust described in subparagraph (A)(ii), which is determined in accordance with regulations prescribed by the Secretary or his delegate to have been applied to purchase the life insurance protection under a contract described in subparagraph (A), is includible in the gross income of the participant for the taxable year when so applied.

(C) In the case of the death of an individual insured under a contract described in subparagraph (A), an amount equal to the cash surrender value of the contract immediately before the death of the insured shall be treated as a payment under such plan or a distribution by such trust, and the excess of the amount payable by reason of the death of the insured over such cash surrender value shall not be includible in gross income under this section and shall be treated as provided in section 101.

(4) Amounts constructively received.—

(A) Assignments or pledges.—If during any taxable year an owner-employee assigns (or agrees to assign) or pledges (or agrees to pledge) any portion of his interest in a trust described in section 401(a) which is exempt from tax under section 501(a) or any portion of the value of a contract purchased as part of a plan described in section 403(a), such portion shall be treated as having been received by such owner-employee as a distribution from such trust or as an amount received under the contract.

(B) Loans on contracts.—If during any taxable year, an owner-employee receives, directly or indirectly, any amount from any insurance company as a loan under a contract purchased by a trust described in section 401(a) which is exempt from tax under section 501(a) or purchased as part of a plan described in section 403(a), and issued by such insurance company, such amount shall be treated as an amount received under the contract.

(5) Penalties applicable to certain amounts received by owner-employees.—

(A) This paragraph shall apply—

(i) to amounts (other than any amount received by an individual in his capacity as a policyholder of an annuity, endowment, or life insurance contract which is in the nature of a dividend or similar distribution) which are received from a qualified trust described in

section 401(a) or under a plan described in section 403(a) and which are received by an individual, who is, or has been, an owner-employee, before such individual attains the age of 59½ years, for any reason other than the individual's becoming disabled (within the meaning of section 213(g)(3)), but only to the extent that such amounts are attributable to contributions paid on behalf of such individual (whether or not paid by him) while he was an owner-employee,

(ii) to amounts which are received from a qualified trust described in section 401(a) or under a plan described in section 403(a) at any time by an individual who is, or has been, an owner-employee, or by the successor of such individual, but only to the extent that such amounts are determined, under regulations prescribed by the Secretary or his delegate, to exceed the benefits provided for such individual under the plan formula, and

(iii) to amounts which are received, by an individual who is, or has been, an owner-employee, by reason of the distribution under the provisions of section 401(e)(2)(E) of his entire interest in all qualified trusts described in section 401(a) and in all plans described in section 403(a).

(B)(i) If the aggregate of the amounts to which this paragraph applies received by any person in his taxable year equals or exceeds $2,500, the increase in his tax for the taxable year in which such amounts are received and attributable to such amounts shall not be less than 110 percent of the aggregate increase in taxes, for the taxable year and the 4 immediately preceding taxable years, which would have resulted if such amounts had been included in such person's gross income ratably over such taxable years.

(ii) If deductions have been allowed under section 404 for contributions paid on behalf of the individual while he is an owner-employee for a number of prior taxable years less than 4, clause (i) shall be applied by taking into account a number of taxable years immediately preceding the taxable year in which the amount was so received equal to such lesser number.

(C) If subparagraph (B) does not apply to a person for the taxable year, the increase in tax of such person for the taxable year attributable to the amounts to which this paragraph applies shall be 110 percent of such increase (computed without regard to this subparagraph).

(D) Subparagraph (A)(ii) of this paragraph shall not apply to any amount to which section 402(a)(2) or 403(a)(2) applies.

(E) For special rules for computation of taxable income for taxable years to which this paragraph applies, see subsection (n)(3).

(6) Owner-employee defined.—For purposes of this subsection, the term "owner-employee" has the meaning assigned to it by section 401(c)(3).

(n) Treatment of Certain Distributions With Respect to Contributions by Self-Employed Individuals.—

(1) Application of subsection.—

(A) Distributions by employees' trust.—Subject to the provisions of subparagraph (C), this subsection shall apply to amounts distributed to a distributee, in the case of an employees' trust described in section 401(a) which is exempt from tax under section 501(a), if the total distributions payable to the distributee with respect to an employee are paid to the distributee within one taxable year of the distributee—

(i) on account of the employee's death,

(ii) after the employee has attained the age of 59½ years, or

(iii) after the employee has become disabled (within the meaning of section 213(g)(3)).

(B) Annuity plans.—Subject to the provisions of subparagraph (C), this subsection shall apply to amounts paid to a payee, in the case of an annuity plan described in section 403(a), if the total amounts payable to the payee with respect to an employee are paid to the payee within one taxable year of the payee—

(i) on account of the employee's death,

(ii) after the employee has attained the age of 59½ years, or

(iii) after the employee has become disabled (within the meaning of section 213(g)(3)).

(C) LIMITATIONS AND EXCEPTIONS.—This subsection shall apply—

(i) only with respect to so much of any distribution or payment to which (without regard to this subparagraph) subparagraph (A) or (B) applies as is attributable to contributions made on behalf of an employee while he was an employee within the meaning of section 401(c)(1), and

(ii) if the recipient is the employee on whose behalf such contributions were made, only if contributions which were allowed as a deduction under section 404 have been made on behalf of such employee while he was an employee within the meaning of section 401(c)(1) for 5 or more taxable years prior to the taxable year in which the total distributions payable or total amounts payable, as the case may be, are paid.

This subsection shall not apply to amounts described in clauses (ii) and (iii) of subparagraph (A) of subsection (m)(5) (but, in the case of amounts described in clause (ii) of such subparagraph, only to the extent that subsection (m)(5) applies to such amounts).

(2) LIMITATION OF TAX.—In any case to which this subsection applies, the tax attributable to the amounts to which this subsection applies for the taxable year in which such amounts are received shall not exceed whichever of the following is the greater:

(A) 5 times the increase in tax which would result from the inclusion in gross income of the recipient of 20 percent of so much of the amount so received as is includible in gross income, or

(B) 5 times the increase in tax which would result if the taxable income of the recipient for such taxable year equaled 20 percent of the amount of the taxable income of the recipient for such taxable year determined under paragraph (3)(A).

(3) DETERMINATION OF TAXABLE INCOME.—Notwithstanding section 63 (relating to definition of taxable income), for purposes only of computing the tax under this chapter attributable to amounts to which this subsection or subsection (m)(5) applies and which are includible in gross income—

(A) the taxable income of the recipient for the taxable year of receipt shall be treated as being not less than the amount by which (i) the aggregate of such amounts so includible in gross income exceeds (ii) the amount of the deductions allowed for such taxable year under section 151 (relating to deductions for personal exemptions); and

(B) in making ratable inclusion computations under paragraph (5)(B) of subsection (m), the taxable income of the recipient for each taxable year involved in such ratable inclusion shall be treated as being not less than the amount required by such paragraph (5)(B) to be treated as includible in gross income for such taxable year.

In any case in which the preceding sentence results in an increase in taxable income for any taxable year, the resulting increase in the taxes imposed by section 1 or 3 for such taxable year shall not be reduced by any credit under part IV of subchapter A (other than section 31 thereof) which, but for this sentence, would be allowable.

(c) CAPITAL GAINS TREATMENT OF CERTAIN EMPLOYEES' TRUST DISTRIBUTIONS.—Section 402(a)(2) of the Internal Revenue Code of 1954 (relating to capital gains treatment for certain distributions) is amended by adding at the end thereof the following new sentence:

This paragraph shall not apply to distributions paid to any distributee to the extent such distributions are attributable to contributions made on behalf of the employee while he was an employee within the meaning of section 401(c)(1).

(d) CAPITAL GAINS TREATMENT OF CERTAIN EMPLOYEES' ANNUITY PAYMENTS.—Section 403(a) of the Internal Revenue Code of 1954 (relating to taxability of a beneficiary under a qualified annuity plan) is amended—

(1) by striking out in paragraph (2)(A)(i) "which meets the requirements of section 401(a)(3), (4), (5), and (6)" and inserting in lieu thereof "described in paragraph (1)";

(2) by adding at the end of paragraph (2)(A) the following new sentence: "This subparagraph shall not apply to amounts paid to any payee to the extent such amounts are attributable to contributions made on behalf of the employee while he was an employee within the meaning of section 401(c)(1)."; and

(3) by adding after paragraph (2) the following new paragraph:

(3) SELF-EMPLOYED INDIVIDUALS.—For purposes of this subsection, the term "employee" includes an individual who is an employee within the meaning of section 401(c)(1), and the employer of such individual is the person treated as his employer under section 401(c)(4).

SEC. 5. PLANS FOR PURCHASE OF UNITED STATES BONDS.

(a) QUALIFIED BOND PURCHASE PLANS.—Part I of subchapter D of chapter 1 of the Internal Revenue Code of 1954 (relating to deferred compensation, etc.) is amended by adding at the end thereof the following new section:

"SEC. 405. QUALIFIED BOND PURCHASE PLANS.

(a) REQUIREMENTS FOR QUALIFICATION.—A plan of an employer for the purchase for and distribution to his employees or their beneficiaries of United States bonds described in subsection (b) shall constitute a qualified bond purchase plan under this section if—

(1) the plan meets the requirements of section 401(a) (3), (4), (5), (6), (7), and (8) and, if applicable, the requirements of section 401(a) (9) and (10) and of section 401(d) (other than paragraphs (1), (5)(B), and (8)); and

(2) contributions under the plan are used solely to purchase for employees or their beneficiaries United States bonds described in subsection (b).

(b) BONDS TO WHICH APPLICABLE.—

(1) CHARACTERISTICS OF BONDS.—This section shall apply only to a bond issued under the Second Liberty Bond Act, as amended, which by its terms, or by regulations prescribed by the Secretary under such Act—

(A) provides for payment of interest, or investment yield, only upon redemption;

(B) may be purchased only in the name of an individual;

(C) ceases to bear interest, or provide investment yield, not later than 5 years after the death of the individual in whose name it is purchased;

(D) may be redeemed before the death of the individual in whose name it is purchased only if such individual—

(i) has attained the age of 59½ years, or

(ii) has become disabled (within the meaning of section 213(g)(3)); and

(E) is nontransferable.

(2) MUST BE PURCHASED IN NAME OF EMPLOYEE.—This section shall apply to a bond described in paragraph (1) only if it is purchased in the name of the employee.

(c) DEDUCTION FOR CONTRIBUTIONS TO BOND PURCHASE PLANS.—Contributions paid by an employer to or under a qualified bond purchase plan shall be allowed as a deduction in an amount determined under section 404 in the same manner and to the same extent as if such contributions were made to a trust described in section 401(a) which is exempt from tax under section 501(a).

(d) TAXABILITY OF BENEFICIARY OF QUALIFIED BOND PURCHASE PLAN.—

(1) GROSS INCOME NOT TO INCLUDE BONDS AT TIME OF DISTRIBUTION.—For purposes of this chapter, in the case of a distributee of a bond described in subsection (b) under a qualified bond purchase plan, or from a trust described in section 401(a) which is exempt from tax under section 501(a), gross income does not include any amount attributable to the receipt of such bond. Upon redemption of such bond, the proceeds shall be subject to taxation under this chapter, but the provisions of section 72 (relating to annuities, etc.) and section 1232 (relating to bonds and other evidences of indebtedness) shall not apply.

(2) Basis.—The basis of any bond received by a distributee under a qualified bond purchase plan—

(A) if such bond is distributed to an employee, or with respect to an employee, who at the time of purchase of the bond, was an employee other than an employee within the meaning of section 401(c)(1), shall be the amount of the contributions by the employee which were used to purchase the bond, and

(B) if such bond is distributed to an employee, or with respect to an employee, who, at the time of purchase of the bond, was an employee within the meaning of section 401(c)(1), shall be the amount of the contributions used to purchase the bond which were made on behalf of such employee and were not allowed as a deduction under subsection (c).

The basis of any bond described in subsection (b) received by a distributee from a trust described in section 401(a) which is exempt from tax under section 501(a) shall be determined under regulations prescribed by the Secretary or his delegate.

(e) Capital Gains Treatment Not To Apply to Bonds Distributed by Trusts.—Section 402(a)(2) shall not apply to any bond described in subsection (b) distributed to any distributee and, for purposes of applying such section, any such bond distributed to any distributee and any such bond to the credit of any employee shall not be taken into account.

(f) Employee Defined.—For purposes of this section, the term "employee" includes an individual who is an employee within the meaning of section 401(c)(1), and the employer of such individual shall be the person treated as his employer under section 401(c)(4).

(g) Proof of Purchase.—At the time of purchase of any bond to which this section applies, proof of such purchase shall be furnished in such form as will enable the purchaser, and the employee in whose name such bond is purchased, to comply with the provisions of this section.

(h) Regulation.—The Secretary or his delegate shall prescribe such regulations as may be necesary to carry out the provisions of this section.

(b) Clerical Amendment.—The table of sections for such part is amended by adding at the end thereof the following new item:

Sec. 405. Qualified bond purchase plans.

SEC. 6. PROHIBITED TRANSACTIONS.

Section 503 of the Internal Revenue Code of 1954 (relating to prohibited transactions) is amended by adding at the end thereof the following new subsection:

(j) Trusts Benefiting Certain Owner-Employees.—

(1) Prohibited transactions.—In the case of a trust described in section 401(a) which is part of a plan providing contributions or benefits for employees some or all of whom are owner-employees (as defined in section 401(c)(3)) who control (within the meaning of section 401(d)(9)(B)) the trade or business with respect to which the plan is established, the term "prohibited transaction" also means any transaction in which such trust, directly or indirectly—

(A) lends any part of the corpus or income of the trust to;

(B) pays any compensation for personal services rendered to the trust to;

(C) makes any part of its services available on a preferential basis to; or

(D) acquires for the trust any property from, or sells any property to;

any person described in subsection (c) or to any such owner-employee, a member of the family (as defined in section 267(c)(4)) of any such owner-employee, or a corporation controlled by any such owner-employee through the ownership, directly or indirectly, of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of the corporation.

(2) Special rule for loans.—For purposes of the application of paragraph (1)(A), the following rules shall apply with respect to a loan made before the date of the enactment of this subsection which would be a pro-

hibited transaction if made in a taxable year beginning after December 31, 1962:

(A) If any part of the loan is repayable prior to December 31, 1965, the renewal of such part of the loan for a period not extending beyond December 31, 1965, on the same terms, shall not be considered a prohibited transactions.

(B) If the loan is repayable on demand, the continuation of the loan beyond December 31, 1965, shall be considered a prohibited transaction.

SEC. 7. OTHER SPECIAL RULES, TECHNICAL CHANGES, AND ADMINISTRATIVE PROVISIONS.

(a) RETIREMENT INCOME CREDIT.—Section 37(c)(1) of the Internal Revenue Code of 1954 (relating to definition of retirement income) is amended—

(1) by striking out subparagraph (A) and inserting in lieu thereof the following:

(A) pensions and annuities (including, in the case of an individual who is, or has been, an employee within the meaning of section 401(c)(1), distributions by a trust described in section 401(a) which is exempt from tax under section 501(a)); and

(2) by striking out "and" at the end of subparagraph (C), by striking out "or" at the end of subparagraph (D) and inserting in lieu thereof "and", and by adding after subparagraph (D) the following new subparagraph:

(E) bonds described in section 405(b)(1) which are received under a qualified bond purchase plan described in section 405(a) or in a distribution from a trust described in section 401(a) which is exempt from tax under section 501(a), or.

(b) ADJUSTED GROSS INCOME.—Section 62 of the Internal Revenue Code of 1954 (relating to the definition of adjusted gross income) is amended by inserting after paragraph (6) the following new paragraph:

(7) PENSION, PROFIT-SHARING, ANNUITY, AND BOND PURCHASE PLANS OF SELF-EMPLOYED INDIVIDUALS.—In the case of an individual who is an employee within the meaning of section 401(c)(1), the deductions allowed by section 404 and section 405(c) to the extent attributable to contributions made on behalf of such individual.

(c) DEATH BENEFITS.—Section 101(b) of the Internal Revenue Code of 1954 (relating to employees' death benefits) is amended—

(1) by striking out clause (ii) of paragraph (2)(B) and inserting in lieu thereof the following:

"(ii) under an annuity contract under a plan described in section 403(a), or"; and

(2) by adding at the end thereof the following new paragraph:

(3) SELF-EMPLOYED INDIVIDUAL NOT CONSIDERED AN EMPLOYEE.—For purposes of this subsection the term "employee" does not include an individual who is an employee within the meaning of section 401(c)(1) (relating to self-employed individuals).

(d) AMOUNTS RECEIVED THROUGH ACCIDENT OR HEALTH INSURANCE.—Section 104(a) of the Internal Revenue Code of 1954 (relating to compensation for injuries or sickness) is amended by adding at the end thereof the following new sentence:

For purposes of paragraph (3), in the case of an individual who is, or has been, an employee within the meaning of section 401(c)(1) (relating to self-

employed individuals), contributions made on behalf of such individual while he was such an employee to a trust described in section 401(a) which is exempt from tax under section 501(a), or under a plan described in section 403(a), shall, to the extent allowed as deductions under section 404, be treated as contributions by the employer which were not includible in the gross income of the employee.

(e) AMOUNTS RECEIVED UNDER ACCIDENT AND HEALTH PLANS.—Section 105 of the Internal Revenue Code of 1954 (relating to amounts received under accident and health plans) is amended by adding at the end thereof the following new subsection:

(g) SELF-EMPLOYED INDIVIDUAL NOT CONSIDERED AN EMPLOYEE.—For purposes of this section, the term "employee" does not include an individual who is an employee within the meaning of section 401(c)(1) (relating to self-employed individuals).

(f) NET OPERATING LOSS DEDUCTION.—Section 172(d)(4) of the Internal Revenue Code of 1954 (relating to nonbusiness deductions of taxpayers other than corporations) is amended—

(1) by striking out "and" at the end of subparagraph (B);

(2) by striking out the period at the end of subparagraph (C) and inserting "; and"; and

(3) by adding after subparagraph (C) the following new subparagraph:

(D) any deduction allowed under section 404 or section 405(c) to the extent attributable to contributions which are made on behalf of an individual who is an employee within the meaning of section 401(c)(1) shall not be treated as attributable to the trade or business of such individual.

(g) CERTAIN LIFE INSURANCE RESERVES.—Section 805(d)(1) of the Internal Revenue Code of 1954 (relating to pension plan reserves) is amended—

(1) by striking out in subparagraph (B) "meeting the requirements of section 401(a) (3), (4), (5), and (6) or" and inserting in lieu thereof "described in section 403(a), or plans meeting"; and

(2) by striking out in subparagraph (C) "and (6)" and inserting in lieu thereof "(6), (7), and (8)".

(h) UNINCORPORATED BUSINESSES ELECTING TO BE TAXED AS CORPORATIONS.—Section 1361(d) of the Internal Revenue Code of 1954 (relating to unincorporated business enterprises electing to be taxed as domestic corporations) is amended by inserting before the period at the end thereof the following: "other than an employee within the meaning of section 401(c)(1) (relating to self-employed individuals), or for purposes of section 405 (relating to qualified bond purchase plans) other than an employee described in section 405(f)".

(i) ESTATE TAX EXEMPTION OF EMPLOYEES' ANNUITIES.—Section 2039 of the Internal Revenue Code of 1954 (relating to exemption from the gross estate of annuities under certain trusts and plans) is amended—

(1) by striking out in subsection (c)(2) "met the requirements of section 401(a) (3), (4), (5), and (6)" and inserting "was a plan described in section 403(a)"; and

(2) by adding at the end of subsection (c) the following new sentence: "For purposes of this subsection, contributions or payments on behalf of the decedent while he was an employee within

the meaning of section 401(c)(1) made under a trust or plan described in paragraph (1) or (2) shall be considered to be contributions or payments made by the decedent."

(j) Gift Tax Exemption of Employees' Annuities.—Section 2517 of the Internal Revenue Code of 1954 (relating to exclusion from gift tax in case of certain annuities under qualified plans) is amended—

(1) by striking out in subsection (a)(2) "met the requirements of section 401(a) (3), (4), (5), and (6)" and inserting in lieu thereof "was a plan described in section 403(a)"; and

(2) by adding at the end of subsection (b) the following new sentence: "For purposes of this subsection, payments or contributions on behalf of an individul while he was an employee within the meaning of section 401(c)(1) made under a trust or plan described in subsection (a) (1) or (2) shall be considered to be payments or contributions made by the employee."

(k) Federal Unemployment Tax Act.—Section 3306(b)(5) of the Internal Revenue Code of 1954 (relating to definition of wages) is amended by striking out subparagraph (B) and inserting in lieu thereof the following new subparagraphs:

(B) under or to an annuity plan which, at the time of such payment, is a plan described in section 403(a); or

(C) under or to a bond purchase plan which, at the time of such payment, is a qualified bond purchase plan described in section 405(a).

(l) Withholding of Income Tax.—Section 3401(a)(12) of the Internal Revenue Code of 1954 (relating to definition of wages) is amended by striking out subparagraph (B) and inserting in lieu thereof the following new subparagraphs:

(B) under or to an annuity plan which, at the time of such payment, is a plan described in section 403(a); or

(C) under or to a bond purchase plan which, at the time of such payment, is a qualified bond purchase plan described in section 405(a).

(m) Information Requirements.—

(1) In general.—Subpart B of part III of subchapter A of chapter 61 of the Internal Revenue Code of 1954 (relating to information concerning transactions with other persons) is amended by adding after section 6046 the following new section:

SEC. 6047. INFORMATION RELATING TO CERTAIN TRUSTS AND ANNUITY AND BOND PURCHASE PLANS.

(a) Trustees and Insurance Companies.—The trustee of a trust described in section 401(a) which is exempt from tax under section 501(a) to which contributions have been paid under a plan on behalf of any owner-employee (as defined in section 401(c)(3)), and each insurance company or other person which is the issuer of a contract purchased by such a trust, or purchased under a plan described in section 403(a), contributions for which have been paid on behalf of any owner-employee, shall file such returns (in such form and at such times), keep such records, make such identification of contracts and funds (and accounts within such funds), and supply such information, as the Secretary or his delegate shall by forms or regulations prescribe.

(b) Owner-Employees.—Every individual on whose behalf contributions have been paid as an owner-employee (as defined in section 401(c)(3))—

(1) to a trust described in section 401(a) which is exempt from tax under section 501(a), or

(2) to an insurance company or other person under a plan described in section 403(a),

shall furnish the trustee, insurance company, or other person, as the case may be, such information at such times and in such form and manner as the Secretary or his delegate shall prescribe by forms or regulations.

(c) EMPLOYEEES UNDER QUALIFIED BOND PURCHASE PLANS.—Every individual in whose name a bond described in section 405(b)(1) is purchased by his employer under a qualified bond purchase plan described in section 405(a), or by a trust described in section 401(a) which is exempt from tax under section 501(a), shall furnish—

(1) to his employer or to such trust, and

(2) to the Secretary (or to such person as the Secretary may by regulations prescribe),

such information as the Secretary or his delegate shall by forms or regulations prescribe.

(d) CROSS REFERENCE.—For criminal penalty for furnishing fraudulent information, see section 7207.

(2) CLERICAL AMENDMENT.—The table of sections for such subpart B is amended by adding after the reference to section 6046 the following:

Sec. 6047. Information relating to certain trusts and annuity and bond purchase plans.

(3) PENALTY.—Section 7207 of the Internal Revenue Code of 1954 (relating to fraudulent returns, statements, or other documents) is amended by adding at the end thereof the following new sentence: "Any person required pursuant to section 6047 (b) or (c) to furnish any information to the Secretary or any other person who willfully furnishes to the Secretary or such other person any information known by him to be fraudulent or to be false as to any material matter shall be fined not more than $1,000, or imprisoned not more than 1 year, or both."

SEC. 8. EFFECTIVE DATE.

The amendments made by this Act shall apply to taxable years beginning after December 31, 1962.

Approved October 10, 1962.

PUBLIC LAW 87–794
EIGHTY-SEVENTH CONGRESS, OCTOBER 11, 1962
H.R. 11970 [16]

An Act to promote the general welfare, foreign policy, and security of the United States through international trade agreements and through adjustment assistance to domestic industry, agriculture, and labor, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

TITLE I—SHORT TITLE AND PURPOSES

SEC. 101. SHORT TITLE.

This Act may be cited as the "Trade Expansion Act of 1962".

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[16] This publication of the law is restricted to excerpts involving internal revenue matters; House Report No. 1818, page 397, this Bulletin; Conference Report No. 2518, page 401, this Bulletin; Senate Report No. 2059 is not published herein.

TITLE III—TARIFF ADJUSTMENT AND OTHER ADJUSTMENT ASSISTANCE

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SEC. 317. TAX ASSISTANCE.

(a) If—

(1) to carry out an adjustment proposal of a firm certified pursuant to section 311, such firm applies for tax assistance under this section within 24 months after the close of a taxable year and alleges in such application that it has sustained a net operating loss for such taxable year,

(2) the Secretary of Commerce determines that any such alleged loss for such taxable year arose predominantly out of the carrying on of a trade or business which was seriously injured, during such year, by the increased imports which the Tariff Commission has determined to result from concessions granted under trade agreements, and

(3) the Secretary of Commerce determines that tax assistance under this section will materially contribute to the economic adjustment of the firm,

then the Secretary of Commerce shall certify such determinations with respect to such firm for such taxable year. No determination or certification under this subsection shall constitute a determination of the existence or amount of any net operating loss for purposes of section 172 of the Internal Revenue Code of 1954.

(b) Effective with respect to net operating losses for taxable years ending after December 31, 1955, subsection (b) of section 172 of the Internal Revenue Code of 1954 (relating to net operating loss carrybacks and carryovers) is amended to read as follows:

(b) NET OPERATING LOSS CARRYBACKS AND CARRYOVERS.—

(1) YEARS TO WHICH LOSS MAY BE CARRIED.—

(A) (i) Except as provided in clause (ii), a net operating loss for any taxable year ending after December 31, 1957, shall be a net operating loss carryback to each of the 3 taxable years preceding the taxable year of such loss.

(ii) In the case of a taxpayer with respect to a taxable year ending on or after December 31, 1962, for which a certification has been issued under section 317 of the Trade Expansion Act of 1962, a net operating loss for such taxable year shall be a net operating loss carryback to each of the 5 taxable years preceding the taxable year of such loss.

(B) Except as provided in subparagraph (C), a net operating loss for any taxable year ending after December 31, 1955, shall be a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss.

(C) In the case of a taxpayer which is a regulated transportation corporation (as defined in subsection (j) (1)), a net operating loss for any taxable year ending after December 31, 1955, shall (except as provided in subsection (j)) be a net operating loss carryover to each of the 7 taxable years following the taxable year of such loss.

(2) AMOUNT OF CARRYBACKS AND CARRYOVERS.—Except as provided in subsections (i) and (j), the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the "loss year") shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the taxable income for any such prior taxable year shall be computed—

(A) with the modifications specified in subsection (d) other than paragraphs (1), (4), and (6) thereof; and

(B) by determining the amount of the net operating loss deduction without regard to the net operating loss for the loss year or for any taxable year thereafter,

and the taxable income so computed shall not be considered to be less than zero.

(3) SPECIAL RULES.—

(A) Paragraph (1) (A) (ii) shall apply only if—

(i) there has been filed, at such time and in such manner as may be prescribed by the Secretary or his delegate, a notice of filing of the application under section 317 of the Trade Expansion Act of 1962 for tax assistance, and, after its issuance, a copy of the certification under such section, and

(ii) the taxpayer consents in writing to the assessment, within such period as may be agreed upon with the Secretary or his delegate, of any deficiency for any year to the extent attributable to the disallowance of a deduction previously allowed with respect to such net operating loss, even though at the time of filing such consent the assessment of such deficiency would otherwise be prevented by the operation of any law or rule of law.

(B) In the case of—

(i) a partnership and its partners, or

(ii) an electing small business corporation under subchapter S and its shareholders,

paragraph (1) (A) (ii) shall apply as determined under regulations prescribed by the Secretary or his delegate. Such paragraph shall apply to a net operating loss of a partner or such a shareholder only if it arose predominantly from losses in respect of which certifications under section 317 of the Trade Expansion Act of 1962 were filed under this section.

(c) Subsection (h) of section 6501 of the Internal Revenue Code of 1954 (relating to limitations on assessment and collection in the case of net operating loss carrybacks) is amended by inserting before the period: ", or within 18 months after the date on which the taxpayer files in accordance with section 172(b) (3) a copy of the certification (with respect to such taxable year) issued under section 317 of the Trade Expansion Act of 1962, whichever is later".

(d) Section 6511(d) (2) (A) of the Internal Revenue Code of 1954 (relating to special period of limitation on credit or refund with respect to net operating loss carrybacks) is amended to read as follows:

(A) PERIOD OF LIMITATION.—If the claim for credit or refund relates to an overpayment attributable to a net operating loss carryback, in lieu of the 3-year period of limitation prescribed in subsection (a), the period shall be that period which ends with the expiration of the 15th day of the 40th month (or the 39th month, in the case of a corporation) following the end of the taxable year of the net operating loss which results in such carryback, or the period prescribed in subsection (c). in respect of such taxable year, whichever expires later; except that—

(i) with respect to an overpayment attributable to a net operating loss carryback to any year on account of a certification issued to the taxpayer under section 317 of the Trade Expansion Act of 1962, the period shall not expire before the expiration of the sixth month following the month in which such certification is issued to the taxpayer, and

(ii) with respect to an overpayment attributable to the creation of, or an increase in, a net operating loss carryback as a result of the elimination of excessive profits by a renegotiation (as defined in section 1481(a) (1) (A)), the period shall not expire before September 1, 1959, or the expiration of the twelfth month following the month in which the agreement or order for the elimination of such excessive profits becomes final, whichever is the later.

In the case of such a claim, the amount of the credit or refund may exceed the portion of the tax paid within the period provided in subsection (b) (2) or (c), whichever is applicable, to the extent of the amount of the overpayment attributable to such carryback.

SEC. 318. PROTECTIVE PROVISIONS.

(a) Each recipient of adjustment assistance under section 313, 314, or 317 shall keep records which fully disclose the amount and disposition by such recipient of the proceeds, if any, of such adjustment assistance, and which will facilitate an effective audit. The recipient shall also keep such other records as the Secretary of Commerce may prescribe.

(b) The Secretary of Commerce and the Comptroller General of the United States shall have access for the purpose of audit and examination to any books, documents, papers, and records of the recipient pertaining to adjustment assistance under sections 313, 314, and 317.

(c) No adjustment assistance shall be extended under section 313, 314, or 317 to any firm unless the owners, partners, or officers certify to the Secretary of Commerce—

(1) the names of any attorneys, agents, and other persons engaged by or on behalf of the firm for the purpose of expediting applications for such adjustment assistance, and

(2) the fees paid or to be paid to any such person.

(d) No financial assistance shall be provided to any firm under section 314 unless the owners, partners, or officers shall execute an agreement binding them and the firm for a period of 2 years after such financial assistance is provided, to refrain from employing, tendering any office or employment to, or retaining for professional services any person who, on the date such assistance or any part thereof was provided, or within one year prior thereto, shall have served as an officer, attorney, agent, or employee occupying a position or engaging in activities which the Secretary of Commerce shall have determined involve discretion with respect to the provision of such financial assistance.

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SEC. 323. WEEKLY AMOUNTS.

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(g) (1) If unemployment insurance is paid under a State law to an adversely affected worker for a week for which—

(A) he receives a trade readjustment allowance, or

(B) he makes application for a trade readjustment allowance and would be entitled (determined without regard to subsection (c) or (e)) to receive such allowance,

the State agency making such payment shall, unless it has been reimbursed for such payment under other Federal law, be reimbursed from funds appropriated pursuant to section 337, to the extent such payment does not exceed the amount of the trade readjustment allowance which such worker would have received, or would have been entitled to receive, as the case may be, if he had not received the State payment. The amount of such reimbursement shall be determined by the Secretary of Labor on the basis of reports furnished to him by the State agency.

(2) In any case in which a State agency is reimbursed under paragraph (1) for payments of unemployment insurance made to an adversely affected worker, such payments, and the period of unemploy-

ment of such worker for which such payments were made, may be disregarded under the State law (and for purposes of applying section 3303 of the Internal Revenue Code of 1954) in determining whether or not an employer is entitled to a reduced rate of contributions permitted by the State law.

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SEC. 338. DEFINITIONS.

For purposes of this chapter—

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(10) The term "State law" means the unemployment insurance law of the State approved by the Secretary of Labor under section 3304 of the Internal Revenue Code of 1954.

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Approved October 11, 1962, 12:15 p.m.

PUBLIC LAW 87–834
EIGHTY-SEVENTH CONGRESS, OCTOBER 16, 1962
H.R. 10650 [17]

An Act to amend the Internal Revenue Code of 1954 to provide a credit for investment in certain depreciable property, to eliminate certain defects and inequities, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE, ETC.

(a) Short Title—This Act may be cited as the "Revenue Act of 1962".

(b) Table of Contents—

[17] House Report No. 1447, page 405, this Bulletin; Senate Report No. 1881, page 707, this Bulletin; and Conference Report No. 2508, page 1129, this Bulletin.

Sec. 6. Mutual savings banks, etc.
- (a) Reserves for losses on loans.
- (b) Foreclosure on property securing loans.
- (c) Definition of domestic building and loan association.
- (d) Clerical amendments.
- (e) Repeal of exemption from certain excise taxes.
- (f) Deduction for dividends or interest paid on deposits.
- (g) Effective dates.

Sec. 7. Distribution by foreign trusts.
- (a) Definitions.
- (b) Accumulation distributions of foreign trusts.
- (c) Allocation of accumulation distributions to preceding years.
- (d) Amounts treated as received in prior years.
- (e) Special rules for foreign trusts.
- (f) Information returns with respect to foreign trusts.
- (g) Failure to file information returns.
- (h) United States person defined.
- (i) Technical amendments.
- (j) Effective date.

Sec. 8. Mutual insurance companies (other than life, marine, and certain fire or flood insurance companies), etc.
- (a) Imposition of tax.
- (b) Taxable investment income.
- (c) Statutory underwriting income or loss.
- (d) Exemption from tax.
- (e) Mutual fire insurance companies operating on basis of premium deposits.
- (f) Election of certain mutual companies to be taxed on total income.
- (g) Technical amendments, etc.
- (h) Effective date.

Sec. 9. Domestic corporations receiving dividends from foreign corporations.
- (a) Foreign taxes deemed paid by domestic corporations.
- (b) Inclusion in gross income of amount equal to taxes deemed paid.
- (c) Determination of source of dividends received from certain foreign corporations.
- (d) Technical amendments.
- (e) Effective date.

Sec. 10. Separate limitation on foreign tax credit with respect to certain interest income.
- (a) Limitation on foreign tax credit.
- (b) Effective date.

Sec. 11. Earned income from sources without the United States.
- (a) Limitation on amount and type of income excluded.
- (b) Computation of employees' contributions.
- (c) Effective dates.

Sec. 12. Controlled foreign corporations.
- (a) In general.
- (b) Technical and clerical amendments.
- (c) Effective date.

Sec. 13. Gain from dispositions of certain depreciable property.
- (a) In general.
- (b) Change in method of depreciation.
- (c) Salvage value of personal property.
- (d) Special rule for charitable contributions of section 1245 property.
- (e) Computation of taxable income for purposes of limitation of percentage depletion deduction.
- (f) Technical amendments.
- (g) Effective dates.

Sec. 14. Foreign investment companies.
- (a) Treatment of sale of stock of foreign investment companies.
- (b) Conforming amendments.
- (c) Effective date.

Sec. 15. Gain from certain sales or exchanges of stock in certain foreign corporations.
- (a) Treatment of gain from the redemption, cancellation, or sale of stock in certain foreign corporations.
- (b) Clerical amendment.
- (c) Effective date.

(c) Amendment of 1954 Code.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

SEC. 2. CREDIT FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY.

(a) Allowance of Credit.—Part IV of subchapter A of chapter 1 (relating to credits against tax) is amended by redesignating section 38 as section 39 and by inserting after section 37 the following new section:

SEC. 38. INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY.

(a) General Rule.—There shall be allowed, as a credit against the tax imposed by this chapter, the amount determined under subpart B of this part.

(b) Regulations.—The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this section and subpart B.

(b) Rules for Computing Credit.—Part IV of subchapter A of chapter 1 is amended by adding at the end thereof the following new subpart:

Subpart B—Rules for Computing Credit for Investment in Certain Depreciable Property

SEC. 46. AMOUNT OF CREDIT.

(a) Determination of Amount.—

(1) General rule.—The amount of the credit allowed by section 38 for the taxable year shall be equal to 7 percent of the qualified investment (as defined in subsection (c)).

(2) Limitation based on amount of tax.—Notwithstanding paragraph (1), the credit allowed by section 38 for the taxable year shall not exceed—

(A) so much of the liability for tax for the taxable year as does not exceed $25,000, plus

(B) 25 percent of so much of the liability for tax for the taxable year as exceeds $25,000.

(3) Liability for tax.—For purposes of paragraph (2), the liability for tax for the taxable year shall be the tax imposed by this chapter for such year, reduced by the sum of the credits allowable under—

(A) section 33 (relating to foreign tax credit),

(B) section 34 (relating to dividends received by individuals),

(C) section 35 (relating to partially tax-exempt interest), and

(D) section 37 (relating to retirement income).

For purposes of this paragraph, any tax imposed for the taxable year by section 531 (relating to accumulated earnings tax) or by section 541 (relating to personal holding company tax) shall not be considered tax imposed by this chapter for such year.

(4) Married individuals.—In the case of a husband or wife who files a separate return, the amount specified under subparagraphs (A) and (B) of paragraph (2) shall be $12,500 in lieu of $25,000. This paragraph shall not apply if the spouse of the taxpayer has no qualified investment for, and no unused credit carryback or carryover to, the taxable year of such spouse which ends within or with the taxpayer's taxable year.

(5) Affiliated groups.—In the case of an affiliated group, the $25,000 amount specified under subparagraphs (A) and (B) of paragraph (2) shall

be reduced for each member of the group by apportioning $25,000 among the members of such group in such manner as the Secretary or his delegate shall by regulations prescribe. For purposes of the preceding sentence, the term "affiliated group" has the meaning assigned to such term by section 1504(a), except that all corporations shall be treated as includible corporations (without any exclusion under section 1504(b)).

(b) CARRYBACK AND CARRYOVER OF UNUSED CREDITS.—

(1) ALLOWANCE OF CREDIT.—If the amount of credit determined under subsection (a)(1) for any taxable year exceeds the limitation provided by subsection (a)(2) for such taxable year (hereinafter in this subsection referred to as "unused credit year"), such excess shall be—

(A) An investment credit carryback to each of the 3 taxable years preceding the unused credit year, and

(B) an investment credit carryover to each of the 5 taxable years following the unused credit year,

and shall be added to the amount allowable as a credit by section 38 for such years, except that such excess may be a carryback only to a taxable year ending after December 31, 1961. The entire amount of the unused credit for an unused credit year shall be carried to the earliest of the 8 taxable years to which (by reason of subparagraphs (A) and (B)) such credit may be carried, and then to each of the other 7 taxable years to the extent that, because of the limitation contained in paragraph (2), such unused credit may not be added for a prior taxable year to which such unused credit may be carried.

(2) LIMITATION.—The amount of the unused credit which may be added under paragraph (1) for any preceding or succeeding taxable year shall not exceed the amount by which the limitation provided by subsection (a)(2) for such taxable year exceeds the sum of—

(A) the credit allowable under subsection (a)(1) for such taxable year, and

(B) the amounts which, by reason of this subsection, are added to the amount allowable for such taxable year and attributable to taxable years preceding the unused credit year.

(3) EFFECT OF NET OPERATING LOSS CARRYBACK.—To the extent that the excess described in paragraph (1) arises by reason of a net operating loss carryback, subparagraph (A) of paragraph (1) shall not apply.

(4) TAXABLE YEAR BEGINNING BEFORE JANUARY 1, 1962.—For purposes of determining the amount of an investment credit carryback that may be added under paragraph (1) for a taxable year beginning before January 1, 1962, and ending after December 31, 1961, the amount of the limitation provided by subsection (a)(2) is the amount which bears the same ratio to such limitation as the number of days in such year after December 31, 1961, bears to the total number of days in such year.

(c) QUALIFIED INVESTMENT.—

(1) IN GENERAL.—For purposes of this subpart, the term "qualified investment" means, with respect to any taxable year, the aggregate of—

(A) the applicable percentage of the basis of each new section 38 property (as defined in section 48(b)) placed in service by the taxpayer during such taxable year, plus

(B) the applicable percentage of the cost of each used section 38 property (as defined in section 48(c)(1)) placed in service by the taxpayer during such taxable year.

(2) APPLICABLE PERCENTAGE.—For purposes of paragraph (1), the applicable percentage for any property shall be determined under the following table:

If the useful life is—	The applicable percentage is—
4 years or more but less than 6 years	33⅓
6 years or more but less than 8 years	66⅔
8 years or more	100

For purposes of this paragraph, the useful life of any property shall be determined as of the time such property is placed in service by the taxpayer.

(3) PUBLIC UTILITY PROPERTY.—

(A) In the case of section 38 property which is public utility property, the amount of the qualified investment shall be 3/7 of the amount determined under paragraph (1).

(B) For purposes of subparagraph (A), the term 'public utility property' means property used predominantly in the trade or business of the furnishing or sale of—

(i) electrical energy, water, or sewage disposal services,

(ii) gas through a local distribution system,

(iii) telephone service, or

(iv) telegraph service by means of domestic telegraph operations (as defined in section 222(a)(5) of the Communications Act of 1934, as amended; 47 U.S.C., sec. 222(a)(5)),

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by an agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof.

(4) CERTAIN REPLACEMENT PROPERTY.—For purposes of paragraph (1), if section 38 property is placed in service by the taxpayer to replace property which was—

(A) destroyed or damaged by fire, storm, shipwreck, or other casualty, or

(B) stolen,

the basis of such section 38 property (in the case of new section 38 property), or the cost of such section 38 property (in the case of used section 38 property), which (but for this paragraph) would be taken into account under paragraph (1) shall be reduced by an amount equal to the amount received by the taxpayer as compensation, by insurance or otherwise, for the property so destroyed, damaged, or stolen, or to the adjusted basis of such property, whichever is the lesser. No reduction in basis or cost shall be made under the preceding sentence in any case in which the reduction in qualified investment attributable to the substitution required by section 47(a)(1) with respect to the property so destroyed, damaged, or stolen (determined without regard to section 47(a)(4)) is greater than the reduction described in the preceding sentence.

(d) LIMITATIONS WITH RESPECT TO CERTAIN PERSONS.—

(1) IN GENERAL.—In the case of—

(A) an organization to which section 593 applies,

(B) a regulated investment company or a real estate investment trust subject to taxation under subchapter M (sec. 851 and following), and

(C) a cooperative organization described in section 1381(a),

the qualified investment and the $25,000 amount specified under subparagraphs (A) and (B) of subsection (a)(2) shall equal such person's ratable share of such items.

(2) RATABLE SHARE.—For purposes of paragraph (1), the ratable share of any person for any taxable year of the items described therein shall be—

(A) in the case of an organization referred to in paragraph (1)(A), 50 percent thereof,

(B) in the case of a regulated investment company or a real estate investment trust, the ratio (i) the numerator of which is its taxable income and (ii) the denominator of which is its taxable income computed without regard to the deduction for dividends paid provided by section 852(b)(2)(D) or 857(b)(2)(C), as the case may be, and

(C) in the case of a cooperative organization, the ratio (i) the numerator of which is its taxable income and (ii) the denominator of which is its taxable income increased by amounts to which section 1382(b) or (c) applies and similar amounts the tax treatment of which is determined without regard to subchapter T (sec. 1381 and following).

For purposes of subparagraph (B) of the preceding sentence, the term "taxable income" means in the case of a regulated investment company its

investment company taxable income (within the meaning of section 852(b)(2)), and in the case of a real estate investment trust its real estate investment trust taxable income (within the meaning of section 857(b)(2)).

SEC. 47. CERTAIN DISPOSITIONS, ETC., OF SECTION 38 PROPERTY.

(a) GENERAL RULE.—Under regulations prescribed by the Secretary or his delegate—

(1) EARLY DISPOSITION, ETC.—If during any taxable year any property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the useful life which was taken into account in computing the credit under section 38, then the tax under this chapter for such taxable year shall be increased by an amount equal to the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would have resulted solely from substituting, in determining qualified investment, for such useful life the period beginning with the time such property was placed in service by the taxpayer and ending with the time such property ceased to be section 38 property.

(2) PROPERTY BECOMES PUBLIC UTILITY PROPERTY.—If during any taxable year any property taken into account in determining qualified investment becomes public utility property (within the meaning of section 46(c)(3)(B)), then the tax under this chapter for such taxable year shall be increased by an amount equal to the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would have resulted solely from treating the property, for purposes of determining qualified investment, as public utility property (after giving due regard to the period before such change in use). If the application of this paragraph to any property is followed by the application of paragraph (1) to such property, proper adjustment shall be made in applying paragraph (1).

(3) CARRYBACKS AND CARRYOVERS ADJUSTED.—In the case of any cessation described in paragraph (1) or any change in use described in paragraph (2), the carrybacks and carryovers under section 46(b) shall be adjusted by reason of such cessation (or change in use).

(4) PROPERTY DESTROYED BY CASUALTY, ETC.—No increase shall be made under paragraph (1) and no adjustment shall be made under paragraph (3) in any case in which—

(A) any property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, on account of its destruction or damage by fire, storm, shipwreck, or other casualty, or by reason of its theft,

(B) section 38 property is placed in service by the taxpayer to replace the property described in subparagraph (A), and

(C) the reduction in basis or cost of such section 38 property described in the first sentence of section 46(c)(4) is equal to or; greater than the reduction in qualified investment which (but for this paragraph) would be made by reason of the substitution required by paragraph (1) with respect to the property described in subparagraph (A).

(b) SECTION NOT TO APPLY IN CERTAIN CASES.—Subsection (a) shall not apply to—

(1) a transfer by reason of death, or

(2) a transaction to which section 381(a) applies.

For purposes of subsection (a), property shall not be treated as ceasing to be section 38 property with respect to the taxpayer by reason of a mere change in the form of conducting the trade or business so long as the property is retained in such trade or business as section 38 property and the taxpayer retains a substantial interest in such trade or business.

(c) SPECIAL RULE.—Any increase in tax under subsection (a) shall not be treated as tax imposed by this chapter for purposes of determining the amount of any credit allowable under subpart A.

SEC. 48. DEFINITIONS; SPECIAL RULES.

(a) SECTION 38 PROPERTY.—

(1) IN GENERAL.—Except as provided in this subsection, the term "section 38 property" means—

(A) tangible personal property, or

(B) other tangible property (not including a building and its structural components) but only if such property—

(i) is used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or

(ii) constitutes a research or storage facility used in connection with any of the activities referred to in clause (i).

Such term includes only property with respect to which depreciation (or amortization in lieu of depreciation) is allowable and having a useful life (determined as of the time such property is placed in service) of 4 years or more.

(2) Property used outside the United States.—

(A) In general.—Except as provided in subparagraph (B), the term "section 38 property" does not include property which is used predominantly outside the United States.

(B) Exceptions.—Subparagraph (A) shall not apply to—

(i) any aircraft which is registered by the Administrator of the Federal Aviation Agency and which is operated to and from the United States;

(ii) rolling stock, of a domestic railroad corporation subject to part I of the Interstate Commerce Act, which is used within and without the United States;

(iii) any vessel documented under the laws of the United States which is operated in the foreign or domestic commerce of the United States;

(iv) any motor vehicle of a United States person (as defined in section 7701(a)(30)) which is operated to and from the United States;

(v) any container of a United States person which is used in the transportation of property to and from the United States; and

(vi) any property (other than a vessel or an aircraft) of a United States person which is used for the purpose of exploring for, developing, removing, or transporting resources from the outer Continental Shelf (within the meaning of section 2 of the Outer Continental Shelf Lands Act, as amended and supplemented; 43 U.S.C., sec. 1331).

(3) Property used for lodging.—Property which is used predominantly to furnish lodging or in connection with the furnishing of lodging shall not be treated as section 38 property. The preceding sentence shall not apply to—

(A) nonlodging commercial facilities which are available to persons not using the lodging facilities on the same basis as they are available to persons using the lodging facilities, and

(B) property used by a hotel or motel in connection with the trade or business of furnishing lodging where the predominant portion of the accommodations is used by transients.

(4) Property used by certain tax-exempt organizations.—Property used by an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by this chapter shall be treated as section 38 property only if such property is used predominantly in an unrelated trade or business the income of which is subject to tax under section 511.

(5) Property used by governmental units.—Property used by the United States, any State or political subdivision thereof, any international organization, or any agency or instrumentality of any of the foregoing shall not be treated as section 38 property.

(6) Livestock.—Livestock shall not be treated as section 38 property.

(b) New Section 38 Property.—For purposes of this subpart, the term "new section 38 property" means section 38 property—

(1) The construction, reconstruction, or erection of which is completed by the taxpayer after December 31, 1961, or

(2) Acquired after December 31, 1961, if the original use of such property commences with the taxpayer and commences after such date.

In applying section 46(c)(1)(A) in the case of property described in paragraph (1), there shall be taken into account only that portion of the basis which is

property attributable to construction, reconstruction, or erection after December 31, 1961.

(c) Used Section 38 Property.—

(1) In general.—For purposes of this subpart, the term "used section 38 property" means section 38 property acquired by purchase after December 31, 1961, which is not new section 38 property. Property shall not be treated as "used section 38 property" if, after its acquisition by the taxpayer, it is used by a person who used such property before such acquisition (or by a person who bears a relationship described in section 179(d)(2) (A) or (B) to a person who used such property before such acquisition).

(2) Dollar limitation.—

(A) In general.—The cost of used section 38 property taken into account under section 46(c)(1)(B) for any taxable year shall not exceed $50,000. If such cost exceeds $50,000, the taxpayer shall select (at such time and in such manner as the Secretary or his delegate shall by regulations prescribe) the items to be taken into account, but only to the extent of an aggregate cost of $50,000. Such a selection, once made may be changed only in the manner, and to the extent, provided by such regulations.

(B) Married individuals.—In the case of a husband or wife who files a separate return, the limitation under subparagraph (A) shall be $25,000 in lieu of $50,000. This subparagraph shall not apply if the spouse of the taxpayer has no used section 38 property which may be taken into account as qualified investment for the taxable year of such spouse which ends within or with the taxpayer's taxable year.

(C) Affiliated groups.—In the case of an affiliated group, the $50,000 amount specified under subparagraph (A) shall be reduced for each member of the group by apportioning $50,000 among the members of such group in accordance with their respective amounts of used section 38 property which may be taken into account.

(D) Partnerships.—In the case of a partnership, the limitation contained in subparagraph (A) shall apply with respect to the partnership and with respect to each partner.

(3) Definitions.—For purposes of this subsection—

(A) Purchase.—The term "purchase" has the meaning assigned to such term by section 179(d) (2).

(B) Cost.—The cost of used section 38 property does not include so much of the basis of such property as is determined by reference to the adjusted basis of other property held at any time by the person acquiring such property. If property is disposed of (other than by reason of its destruction or damage by fire, storm, shipwreck, or other casualty, or its theft) and used section 38 property similar or related in service or use is acquired as a replacement therefor in a transaction to which the preceding sentence does not apply, the cost of the used section 38 property acquired shall be its basis reduced by the adjusted basis of the property replaced. The cost of used section 38 property shall not be reduced with respect to the adjusted basis of any property disposed of if, by reason of section 47, such disposition involved an increase of tax or a reduction of the unused credit carrybacks or carryovers described in section 46(b).

(C) Affiliated group.—The term "affiliated group" has the meaning assigned to such term by section 1504(a), except that—

(i) the phrase "more than 50 percent" shall be substituted for the phrase "at least 80 percent" each place it appears in section 1504(a), and

(ii) all corporations shall be treated as includible corporations (without any exclusion under section 1504(b).

(d) Certain Leased Property.—A person (other than a person referred to in section 46(d)) who is a lessor of property may (at such time, in such manner, and subject to such conditions as are provided by regulations prescribed by the Secretary or his delegate) elect with respect to any new section 38 property to treat the lessee as having acquired such property for an amount equal to—

(1) if such property was constructed by the lessor (or by a corporation which controls or is controlled by the lessor within the meaning of section 368(c)), the fair market value of such property, or

(2) if paragraph (1) does not apply, the basis of such property to the lessor.

The election provided by the preceding sentence may be made only with respect to property which would be new section 38 property if acquired by the lessee. For purposes of the preceding sentence and section 46(c), the useful life of property in the hands of the lessee is the useful life of such property in the hands of the lessor. If a lessor makes the election provided by this subsection with respect to any property, the lessee shall be treated for all purposes of this subpart as having acquired such property. If a lessor makes the election provided by this subsection with respect to any property, then, under regulations prescribed by the Secretary or his delegate, subsection (g) shall not apply with respect to such property and the deductions otherwise allowable under section 162 to the lessee for amounts paid to the lessor under the lease shall be adjusted in a manner consistent with the provisions of subsection (g).

(e) Subchapter S Corporations.—In the case of an electing small business corporation (as defined in section 1371)—

(1) the qualified investment for each taxable year shall be apportioned pro rata among the persons who are shareholders of such corporation on the last day of such taxable year; and

(2) any person to whom any investment has been apportioned under paragraph (1) shall be treated (for purposes of this subpart) as the taxpayer with respect to such investment, and such investment shall not (by reason of such apportionment) lose its character as an investment in new section 38 property or used section 38 property, as the case may be.

(f) Estates and Trusts.—In the case of an estate or trust—

(1) the qualified investment for any taxable year shall be apportioned between the estate or trust and the beneficiaries on the basis of the income of the estate or trust allocable to each,

(2) any beneficiary to whom any investment has been apportioned under paragraph (1) shall be treated (for purposes of this subpart) as the taxpayer with respect to such investment, and such investment shall not (by reason of such apportionment) lose its character as an investment in new section 38 property or used section 38 property, as the case may be, and

(3) the $25,000 amount specified under subparagraphs (A) and (B) of section 46(a)(2) applicable to such estate or trust shall be reduced to an amount which bears the same ratio to $25,000 as the amount of the qualified investment allocated to the estate or trust under paragraph (1) bears to the entire amount of the qualified investment.

(g) Adjustments to Basis of Property.—

(1) In general.—The basis of any section 38 property shall be reduced, for purposes of this subtitle other than this subpart, by an amount equal to 7 percent of the qualified investment as determined under section 46(c) with respect to such property.

(2) Certain dispositions, etc.—If the tax under this chapter is increased for any taxable year under paragraph (1) or (2) of section 47(a) or an adjustment in carrybacks or carryovers is made under paragraph (3) of such section, the basis of the property described in such paragraph (1) or (2), as the case may be (immediately before the event on account of which such paragraph (1), (2), or (3) applies), shall be increased by an amount equal to the portion of such increase and the portion of such adjustment attributable to such property.

(h) Cross Reference.—For application of this subpart to certain acquiring corporations, see section 381(c)(23).

(c) Deduction for Unused Credit.—Part VI of subchapter B of chapter 1 (relating to itemized deductions for individuals and corporations) is amended by adding at the end thereof the following new section:

SEC. 181. DEDUCTION FOR CERTAIN UNUSED INVESTMENT CREDIT.

If the amount of the credit determined under section 46(a)(1) for any taxable year exceeds the limitation provided by section 46(a)(2) for such taxable year and if the amount of such excess has not, after the application of section 46(b), been allowed to the taxpayer as a credit under section 38 for any taxable year, then an amount equal to the amount of such excess not so allowed as a credit shall be allowed to the taxpayer as a deduction for the first taxable year following the last taxable year in which such excess could under section 46(b) have been allowed as a credit. If a taxpayer dies or ceases to exist prior to the first taxable year following the last taxable year in which the excess described in the preceding sentence could under section 46(b) have been allowed as a credit, the amount described in the preceding sentence, or the proper portion thereof, shall, under regulations prescribed by the Secretary or his delegate, be allowed to the taxpayer as a deduction for the taxable year in which such death or cessation occurs.

(d) CERTAIN CORPORATE ACQUISITIONS.—Section 381(c) (relating to items taken into account in certain corporate acquisitions) is amended by adding at the end thereof the following new paragraph:

(23) CREDIT UNDER SECTION 38 FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY.—The acquiring corporation shall take into account (to the extent proper to carry out the purposes of this section and section 38, and under such regulations as may be prescribed by the Secretary or his delegate) the items required to be taken into account for purposes of section 38 in respect of the distributor or transferor corporation.

(e) STATUTES OF LIMITATIONS AND INTEREST RELATING TO INVESTMENT CREDIT CARRYBACKS.—

(1) ASSESSMENT AND COLLECTION.—Section 6501 (relating to limitations on assessment and collection) is amended by redesignating subsection (j) as subsection (k), and inserting after subsection (i) the following new subsection:

(j) INVESTMENT CREDIT CARRYBACKS.—In the case of a deficiency attributable to the application to the taxpayer of an investment credit carryback, such deficiency may be assessed at any time before the expiration of the period within which a deficiency for the taxable year of the unused investment credit which results in such carryback may be assessed.

(2) CREDIT OR REFUND.—Subsection (d) of section 6511 (relating to limitations on credit or refund) is amended by adding after paragraph (3) thereof the following new paragraph:

(4) SPECIAL PERIOD OF LIMITATION WITH RESPECT TO INVESTMENT CREDIT CARRYBACKS.—

(A) PERIOD OF LIMITATION.—If the claim for credit or refund relates to an overpayment attributable to an investment credit carryback, in lieu of the 3-year period of limitation prescribed in subsection (a), the period shall be that period which ends with the expiration of the 15th day of the 40th month (or 39th month, in the case of a corporation) following the end of the taxable year of the unused investment credit which results in such carryback, or the period prescribed in subsection (c) in respect of such taxable year, whichever expires later. In the case of such a claim, the amount of the credit or refund may exceed the portion of the tax paid within the period provided in subsection (b)(2) or (c), whichever is applicable, to the extent of the amount of the overpayment attributable to such carryback.

(B) APPLICABLE RULES.—If the allowance of a credit or refund of an overpayment of tax attributable to an investment credit carryback is otherwise prevented by the operation of any law or rule of law other than section 7122, relating to compromises, such credit or refund may be allowed or made, if claim therefor is filed within the period provided in

subparagraph (A) of this paragraph. In the case of any such claim for credit or refund, the determination by any court, including the Tax Court, in any proceeding in which the decision of the court has become final, shall not be conclusive with respect to the investment credit, and the effect of such credit, to the extent that such credit is affected by a carryback which was not in issue in such proceeding.

(3) Interest on underpayments.—Section 6601(e) (relating to interest on underpayment, nonpayment, or extensions of time for payment, of tax) is amended to read as follows:

(e) Income Tax Reduced by Carryback.—

(1) Net operating loss carryback.—If the amount of any tax imposed by subtitle A is reduced by reason of a carryback of a net operating loss, such reduction in tax shall not affect the computation of interest under this section for the period ending with the last day of the taxable year in which the net operating loss arises.

(2) Investment credit carryback.—If the credit allowed by section 38 for any taxable year is increased by reason of an investment credit carryback, such increase shall not affect the computation of interest under this section for the period ending with the last day of the taxable year in which the investment credit carryback arises.

(4) Interest on overpayments.—Section 6611(f) (relating to interest on overpayments) is amended to read as follows:

(f) Refund of Income Tax Caused by Carryback.—

(1) Net operating loss carryback.—For purposes of subsection (a), if any overpayment of tax imposed by subtitle A results from a carryback of a net operating loss, such overpayment shall be deemed not to have been made prior to the close of the taxable year in which such net operating loss arises.

(2) Investment credit carryback.—For purposes of subsection (a), if any overpayment of tax imposed by subtitle A results from an investment credit carryback, such overpayment shall be deemed not to have been made prior to the close of the taxable year in which such investment credit carryback arises.

(f) Technical Amendment.—Section 1016(a) (relating to adjustments to basis) is amended—

(1) by striking out the period at the end of paragraph (18) and inserting in lieu thereof a semicolon; and

(2) by adding after paragraph (18) the following new paragraph:

(19) to the extent provided in section 48(g) in the case of property which is or has been section 38 property (as defined in section 48(a));.

(g) Clerical Amendments.—

(1) Part IV of subchapter A of chapter 1 is amended by inserting after the heading and before the table of sections the following:

Subpart A. Credits allowable.
Subpart B. Rules for computing credit for investment in certain depreciable property.

Subpart A—Credits Allowable

(2) The table of sections for part IV of subchapter A of chapter 1 is amended by striking out

Sec. 38. Overpayments of tax.

and inserting in lieu thereof

Sec. 38. Investment in certain depreciable property.
Sec. 39. Overpayments of tax.

(3) The table of sections for part VI of subchapter B of chapter 1 is amended by adding at the end thereof the following:

Sec. 181. Deduction for certain unused investment credit.

(h) Effective Date.—The amendments made by this section shall apply with respect to taxable years ending after December 31, 1961.

SEC. 3. APPEARANCES, ETC., WITH RESPECT TO LEGISLATION.

(a) In General.—Section 162 (relating to trade or business expenses) is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

(e) Appearances, etc., With Respect to Legislation.—

(1) In general.—The deduction allowed by subsection (a) shall include all the ordinary and necessary expenses (including, but not limited to, traveling expenses described in subsection (a)(2) and the cost of preparing testimony) paid or incurred during the taxable year in carrying on any trade or business—

(A) in direct connection with appearances before, submission of statements to, or sending communications to, the committees, or individual members, of Congress or of any legislative body of a State, a possession of the United States, or a political subdivision of any of the foregoing with respect to legislation or proposed legislation of direct interest to the taxpayer, or

(B) in direct connection with communication of information between the taxpayer and an organization of which he is a member with respect to legislation or proposed legislation of direct interest to the taxpayer and to such organization,

and that portion of the dues so paid or incurred with respect to any organization of which the taxpayer is a member which is attributable to the expenses of the activities described in subparagraphs (A) and (B) carried on by such organization.

(2) Limitation.—The provisions of paragraph (1) shall not be construed as allowing the deduction of any amount paid or incurred (whether by way of contribution, gift, or otherwise)—

(A) for participation in, or intervention in, any political campaign on behalf of any candidate for public office, or

(B) in connection with any attempt to influence the general public, or segments thereof, with respect to legislative matters, elections, or referendums.

(b) Effective Date.—The amendments made by this section shall apply to taxable years beginning after December 31, 1962.

SEC. 4. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES.

(a) Denial of Deductions.—

(1) Part IX of subchapter B of chapter 1 (relating to items not deductible in computing taxable income) is amended by adding at the end thereof the following new section:

SEC. 274. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES.

(a) Entertainment, Amusement, or Recreation.—

(1) In general.—No deduction otherwise allowable under this chapter shall be allowed for any item—

(A) Activity.—With respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes that the item was directly related to, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that such item was associated with, the active conduct of the taxpayer's trade or business, or

(B) Facility.—With respect to a facility used in connection with an activity referred to in subparagraph (A), unless the taxpayer estab-

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lishes that the facility was used primarily for the furtherance of the taxpayer's trade or business and that the item was directly related to the active conduct of such trade or business,

and such deduction shall in no event exceed the portion of such item directly related to, or, in the case of an item described in subparagraph (A) directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), the portion of such item associated with, the active conduct of the taxpayer's trade or business.

(2) Special rules.—For purposes of applying paragraph (1)—

(A) Dues or fees to any social, athletic, or sporting club or organization shall be treated as items with respect to facilities.

(B) An activity described in section 212 shall be treated as a trade or business.

(b) Gifts.—

(1) Limitations.—No deduction shall be allowed under section 162 or section 212 for any expense for gifts made directly or indirectly to any individual to the extent that such expense, when added to prior expenses of the taxpayer for gifts made to such individual during the same taxable year, exceeds $25. For purposes of this section, the term "gift" means any item excludable from gross income of the recipient under section 102 which is not excludable from his gross income under any other provision of this chapter, but such term does not include—

(A) an item having a cost to the taxpayer not in excess of $4.00 on which the name of the taxpayer is clearly and permanently imprinted and which is one of a number of identical items distributed generally by the taxpayer,

(B) a sign, display rack, or other promotional material to be used on the business premises of the recipient, or

(C) an item of tangible personal property having a cost to the taxpayer not in excess of $100 which is awarded to an employee by reason of length of service or for safety achievement.

(2) Special rules.—

(A) In the case of a gift by a partnership, the limitation contained in paragraph (1) shall apply to the partnership as well as to each member thereof.

(B) For purposes of paragraph (1), a husband and wife shall be treated as one taxpayer.

(c) Traveling.—In the case of any individual who is traveling away from home in pursuit of a trade or business or in pursuit of an activity described in section 212, no deduction shall be allowed under section 162 or section 212 for that portion of the expenses of such travel otherwise allowable under such section which, under regulations prescribed by the Secretary or his delegate, is not allocable to such trade or business or to such activity. This subsection shall not apply to the expenses of any travel away from home which does not exceed one week or where the portion of the time away from home which is not attributable to the pursuit of the taxpayer's trade or business or an activity described in section 212 is less than 25 percent of the total time away from home on such travel.

(d) Substantiation Required.—No deduction shall be allowed—

(1) under section 162 or 212 for any traveling expense (including meals and lodging while away from home),

(2) for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity, or

(3) for any expense for gifts,

unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility, or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons entertained, using the facility, or receiving the gift. The Secretary or his delegate may by regulations provide that some or all of the requirements of the preceding sentence shall not apply in the case of an expense which does not exceed an amount prescribed pursuant to such regulations.

(e) SPECIFIC EXCEPTIONS TO APPLICATION OF SUBSECTION.—(a).—Subsection (a) shall not apply to—

(1) BUSINESS MEALS.—Expenses for food and beverages furnished to any individual under circumstances which (taking into account the surroundings in which furnished, the taxpayer's trade, business, or income-producing activity and the relationship to such trade, business, or activity of the persons to whom the food and beverages are furnished) are of a type generally considered to be conducive to a business discussion.

(2) FOOD AND BEVERAGES FOR EMPLOYEES.—Expenses for food and beverages (and facilities used in connection therewith) furnished on the business premises of the taxpayer primarily for his employees.

(3) EXPENSES TREATED AS COMPENSATION.—Expenses for goods, services, and facilities, to the extent that the expenses are treated by the taxpayer, with respect to the recipient of the entertainment, amusement, or recreation, as compensation to an employee on the taxpayer's return of tax under this chapter and as wages to such employee for purposes of charter 24 (relating to withholding of income tax at source on wages).

(4) REIMBURSED EXPENSES.—Expenses paid or incurred by the taxpayer, in connection with the performance by him of services for another person (whether or not such other person is his employer), under a reimbursement or other expense allowance arrangement with such other person, but this paragraph shall apply—

(A) where the services are performed for an employer, only if the employer has not treated such expenses in the manner provided in paragraph (3), or

(B) where the services are performed for a person other than an employer, only if the taxpayer accounts (to the extent provided by subsection (d)) to such person.

(5) RECREATIONAL, ETC., EXPENSES FOR EMPLOYEES.—Expenses for recreational, social, or similar activities (including facilities therefor) primarily for the benefit of employees (other than employees who are officers, shareholders or other owners, or highly compensated employees). For purposes of this paragraph, an individual owning less than a 10-percent interest in the taxpayer's trade or business shall not be considered a shareholder or other owner, and for such purposes an individual shall be treated as owning any interest owned by a member of his family (within the meaning of section 267(c)(4).

(6) EMPLOYEE, STOCKHOLDER, ETC., BUSINESS MEETINGS.—Expenses incurred by a taxpayer which are directly related to business meetings of his employees, stockholders, agents, or directors.

(7) MEETINGS OF BUSINESS LEAGUES, ETC.—Expenses directly related and necessary to attendance at a business meeting or convention of any organization described in section 501(c)(6) (relating to business leagues, chambers of commerce, real estate boards, and boards of trade) and exempt from taxation under section 501(a).

(8) ITEMS AVAILABLE TO PUBLIC.—Expenses for goods, services, and facilities made available by the taxpayer to the general public.

(9) ENTERTAINMENT SOLD TO CUSTOMERS.—Expenses for goods or services (including the use of facilities) which are sold by the taxpayer in a bona fide transaction for an adequate and full consideration in money or money's worth.

For purposes of this subsection, any item referred to in subsection (a) shall be treated as an expense.

(f) INTEREST, TAXES, CASUALTY LOSSES, ETC.—This section shall not apply to any deduction allowable to the taxpayer without regard to its connection with his trade or business (or with his income-producing activity). In the case of a taxpayer which is not an individual, the preceding sentence shall be applied as if it were an individual.

(g) TREATMENT OF ENTERTAINMENT, ETC., TYPE FACILITY.—For purposes of this chapter, if deductions are disallowed under subsection (a) with respect to any portion of a facility, such portion shall be treated as an asset which is used for personal, living, and family purposes (and not as an asset used in the trade or business).

(h) REGULATORY AUTHORITY.—The Secretary or his delegate shall prescribe such regulations as he may deem necessary to carry out the purposes of this section, including regulations prescribing whether subsection (a) or subsection (b) applies in cases where both such subsections would otherwise apply.

(2) The table of sections for such part IX is amended by adding at the end thereof the following:

Sec. 274. Disallowance of certain entertainment, etc., expenses.

(b) TRAVELING EXPENSES.—Section 162(a)(2) (relating to traveling expenses) is amended by striking out "(including the entire amount expended for meals and lodging)" and inserting in lieu thereof "(including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to taxable years ending after December 31, 1962, but only in respect of periods after such date.

SEC. 5. AMOUNT OF DISTRIBUTION WHERE CERTAIN FOREIGN CORPORATIONS DISTRIBUTE PROPERTY IN KIND.

(a) AMOUNT DISTRIBUTED.—Section 301(b)(1) (relating to amount distributed to corporate distributees) is amended by adding at the end thereof the following new subparagraph:

(C) CERTAIN CORPORATE DISTRIBUTEES OF FOREIGN CORPORATION.—Notwithstanding subparagraph (B), if the shareholder is a corporation and the distributing corporation is a foreign corporation, the amount taken into account with respect to property (other than money) shall be the fair market value of such property; except that if any deduction is allowable under section 245 with respect to such distribution, then the amount taken into account shall be the sum (determined under regulations prescribed by the Secretary or his delegate) of—

(i) the proportion of the adjusted basis of such property (or, if lower, its fair market value) properly attributable to gross income from sources within the United States, and

(ii) the proportion of the fair market value of such property properly attributable to gross income from sources without the United States.

(b) BASIS.—Section 301(d) (relating to basis of property) is amended by adding at the end thereof the following new paragraph:

(3) CERTAIN CORPORATE DISTRIBUTEES OF FOREIGN CORPORATION.—In the case of property described in subparagraph (C) of subsection (b)(1), the basis shall be determined by substituting the amount determined under such subparagraph (C) for the amount described in paragraph (2) of this subsection.

(c) DIVIDENDS RECEIVED FROM CERTAIN FOREIGN CORPORATIONS.—

(1) Section 245 (relating to dividends received from certain foreign corporations) is amended by adding at the end thereof the following new subsection:

(b) PROPERTY DISTRIBUTIONS.—For purposes of subsection (a), the amount of any distribution of property other than money shall be the amount determined by applying section 301(b)(1)(B).

(2) Section 245 is amended by striking out "In the case of" and inserting in lieu thereof "(a) GENERAL RULE.—In the case of".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to distributions made after December 31, 1962.

SEC. 6. MUTUAL SAVINGS BANKS, ETC.

(a) RESERVES FOR LOSSES ON LOANS.—Section 593 is amended to read as follows:

SEC. 593. RESERVES FOR LOSSES ON LOANS.

(a) ORGANIZATIONS TO WHICH SECTION APPLIES.—This section shall apply to any mutual savings bank not having capital stock represented by shares, domestic building and loan association, or cooperative bank without capital stock organized and operated for mutual purposes and without profit.

(b) ADDITION TO RESERVES FOR BAD DEBTS.—

(1) IN GENERAL.—For purposes of section 166(c), the reasonable addition for the taxable year to the reserve for bad debts of any taxpayer described in subsection (a) shall be an amount equal to the sum of—

(A) the amount determined under section 166(c) to be a reasonable addition to the reserve for losses on nonqualifying loans, plus

(B) the amount determined by the taxpayer to be a reasonable addition to the reserve for losses on qualifying real property loans, but such amount shall not exceed the amount determined under paragraph (2), (3), or (4), whichever amount is the largest, but the amount determined under this subparagraph shall in no case be greater than the larger of—

(i) the amount determined under paragraph (4), or

(ii) the amount which, when added to the amount determined under subparagraph (A), equals the amount by which 12 percent of the total deposits or withdrawable accounts of depositors of the taxpayer at the close of such year exceeds the sum of its surplus, undivided profits, and reserves at the beginning of such year (taking into account any portion thereof attributable to the period before the first taxable year beginning after December 31, 1951).

(2) PERCENTAGE OF TAXABLE INCOME METHOD.—The amount determined under this paragraph for the taxable year shall be the excess of—

(A) an amount equal to 60 percent of the taxable income for such year, over

(B) the amount referred to in paragraph (1)(A) for such year, but the amount determined under this paragraph shall not exceed the amount necessary to increase the balance (as of the close of the taxable year) of the reserve for losses on qualifying real property loans to 6 percent of such loans outstanding at such time. For purposes of this paragraph, taxable income shall be computed (i) by excluding from gross income any amount included therein by reason of subsection (f), and (ii) without regard to any deduction allowable for any addition to the reserve for bad debts.

(3) PERCENTAGE OF REAL PROPERTY LOANS METHOD.—The amount determined under this paragraph for the taxable year shall be an amount equal to the amount necessary to increase the balance (as of the close of the taxable year) of the reserve for losses on qualifying real property loans to an amount equal to—

(A) 3 percent of such loans outstanding at such time, plus

(B) in the case of a taxpayer which is a new company and which does not have capital stock with respect to which distributions of property (as defined in section 317(a)) are not allowable as a deduction under section 591, an amount equal to—

(i) 2 percent of so much of the amount of such loans outstanding at such time as does not exceed $4,000,000, reduced (but not below zero) by

(ii) the amount, if any, of the balance (as of the close of such taxable year) of the taxpayer's supplemental reserve for losses on loans.

For purposes of subparagraph (B), a taxpayer is a new company for any taxable year only if such taxable year begins not more than 10 years after the first day on which it (or any predecessor) was authorized to do business as an organization described in subsection (a).

(4) EXPERIENCE METHOD.—The amount determined under this paragraph for the taxable year shall be an amount equal to the amount determined under section 166(c) (without regard to this subsection) to be a reasonable addition to the reserve for losses on qualifying real property loans.

(5) LIMITATION IN CASE OF CERTAIN DOMESTIC BUILDING AND LOAN ASSOCIATIONS.—If the percentage of the assets of a domestic building and loan association which are not assets described in section 7701(a)(19)(D)(ii) exceeds 36 percent for the taxable year (as determined for purposes of section 7701(a)(19) for such year), the amount determined under paragraph (2), and the amount determined under paragraph (3), shall in each case be the amount (determined without regard to this paragraph but with regard to the limits contained in paragraphs (2), (3), and (1)(B)) reduced by the amount determined under the following table:

If the percentage exceeds—	but does not exceed—	the reduction shall be the following proportion of the amount so determined without regard to this paragraph—
36 percent	37 percent	1/12
37 percent	38 percent	1/6
38 percent	39 percent	1/4
39 percent	40 percent	1/3
40 percent	41 percent	5/12

(c) TREATMENT OF RESERVES FOR BAD DEBTS.—

(1) ESTABLISHMENT OF RESERVES.—Each taxpayer described in subsection (a) which uses the reserve method of accounting for bad debts shall establish and maintain a reserve for losses on qualifying real property loans, a reserve for losses on nonqualifying loans, and a supplemental reserve for losses on loans. For purposes of this title, such reserves shall be treated as reserves for bad debts, but no deduction shall be allowed for any addition to the supplemental reserve for losses on loans.

(2) ALLOCATION OF PRE-1963 RESERVES.—For purposes of this section, the pre-1963 reserves shall, as of the close of December 31, 1962, be allocated to, and constitute the opening balance of—

(A) the reserve for losses on nonqualifying loans,

(B) the reserve for losses on qualifying real property loans, and

(C) the supplemental reserve for losses on loans.

(3) METHOD OF ALLOCATION.—The allocation provided by paragraph (2) shall be made—

(A) first, to the reserve described in paragraph (2)(A), to the extent such reserve is not increased above the amount which would be a reasonable addition under section 166(c) for a period in which the nonqualifying loans increased from zero to the amount thereof outstanding at the close of December 31, 1962;

(B) second, to the reserve described in paragraph (2)(B), to the extent such reserve is not increased above the amount which would be determined under paragraph (3)(A) or (4) of subsection (b) (whichever such amount is the larger) for a period in which the qualifying real property loans increased from zero to the amount thereof outstanding at the close of December 31, 1962; and

(C) then to the supplemental reserve for losses on loans.

(4) PRE-1963 RESERVES DEFINED.—For purposes of this subsection, the term "pre-1963 reserves" means the net amount, determined as of the close of December 31, 1962 (after applying subsection (d)(1)), accumulated in the reserve for bad debts pursuant to section 166(c) (or the corresponding provisions of prior revenue laws) for taxable years beginning after December 31, 1951.

(5) CERTAIN PRE-1952 SURPLUS.—If after the application of paragraph (3), the opening balance of the reserve described in paragraph (2)(B) is less than the amount described in paragraph (3)(B), then, for purposes of this subsection, the term "pre-1963 reserves" includes so much of the surplus,

undivided profits, and bad debt reserves (determined as of December 31, 1962) attributable to the period before the first taxable year beginning after December 31, 1951, as does not exceed the amount by which such opening balance is less than the amount described in paragraph (3)(B). For purposes of the preceding sentence, the surplus, undivided profits, and bad debt reserves attributable to the period before the first taxable year beginning after December 31, 1951, shall be reduced by the amount thereof which is attributable to interest which would have been excludable from gross income under section 22(b)(4) of the Internal Revenue Code of 1939 (relating to interest on governmental obligations) or the corresponding provisions of prior laws. Notwithstanding the second sentence of paragraph (1), any amount which, by reason of the application of the first sentence of this paragraph, is allocated to the reserve described in paragraph (2)(B) shall not be treated as a reserve for bad debts for any purpose other than determining the amount referred to in subsection (b)(1)(B), and for such purpose such amount shall be treated as remaining in such reserve.

(6) Charging of bad debts to reserves.—Any debt becoming worthless or partially worthless in respect of a qualifying real property loan shall be charged to the reserve for losses on such loans, and any debt becoming worthless or partially worthless in respect of a nonqualifying loan shall be charged to the reserve for losses on nonqualifying loans; except that any such debt may, at the election of the taxpayer, be charged in whole or in part to the supplemental reserve for losses on loans.

(d) Taxable Years Beginning in 1962 and Ending in 1963.—In the case of a taxable year beginning before January 1, 1963, and ending after December 31, 1962, of a taxpayer described in subsection (a) which uses the reserve method of accounting for bad debts, the taxable income shall be the sum of—

(1) that portion of the taxable income allocable to the part of the taxable year occurring before January 1, 1963, reduced by the amount of the deduction for an addition to a reserve for bad debts which would be allowable under section 166(c) (without regard to the amendments made by section 6 of the Revenue Act of 1962) if such part year constituted a taxable year, plus

(2) that portion of the taxable income allocable to the part of the taxable year occurring after December 31, 1962, reduced by the amount of the deduction for an addition to a reserve for bad debts which would be allowed under section 166(c) (taking into account the amendments made by section 6 of the Revenue Act of 1962) if such part year constituted a taxable year.

For purposes of the preceding sentence, the taxable income shall be determined without regard to any deduction under section 166(c), and the portion thereof allocable to each part year shall be determined on the basis of the ratio which the number of days in such part year bears to the number of days in the entire taxable year.

(e) Loans Defined.—For purposes of this section—

(1) Qualifying real property loans.—The term "qualifying real property loan" means any loan secured by an interest in improved real property or secured by an interest in real property which is to be improved out of the proceeds of the loan, but such term does not include—

(A) any loan evidenced by a security (as defined in section 165(g)(2)(C);

(B) any loan, whether or not evidenced by a security (as defined in section 165(g)(2)(C)), the primary obligor on which is—

(i) a government or political subdivision or instrumentality thereof;

(ii) a bank (as defined in section 581); or

(iii) another member of the same affiliated group;

(C) any loan, to the extent secured by a deposit in or share of the taxpayer; or

(D) any loan which, within a 60-day period beginning in one taxable year of the creditor and ending in its next taxable year, is made or acquired and then repaid or disposed of, unless the transactions by which such loan was made or acquired and then repaid or disposed of are established to be for bona fide business purposes.

For purposes of subparagraph (B) (iii), the term "affiliated group" has the meaning assigned to such term by section 1504(a); except that (i) the phrase "more than 50 percent" shall be substituted for the phrase "at least 80 percent" each place it appears in section 1504(a), and (ii) all corporations shall be treated as includible corporations (without any exclusion under section 1504(b)).

(2) NONQUALIFYING LOANS.—The term "nonqualifying loan" means any loan which is not a qualifying real property loan.

(3) LOAN.—The term "loan" means debt, as the term "debt" is used in section 166.

(f) DISTRIBUTIONS TO SHAREHOLDERS.—

(1) IN GENERAL.—For purposes of this chapter, any distribution of property (as defined in section 317(a)) by a domestic building and loan association to a shareholder with respect to its stock, if such distribution is not allowable as a deduction under section 591, shall be treated as made—

(A) first out of its earnings and profits accumulated in taxable years beginning after December 31, 1951, to the extent thereof,

(B) then out of the reserve for losses on qualifying real property loans, to the extent additions to such reserve exceed the additions which would have been allowed under subsection (b) (4),

(C) then out of the supplemental reserve for losses on loans, to the extent thereof,

(D) then out of such other accounts as may be proper.

This paragraph shall apply in the case of any distribution in redemption of stock or in partial or complete liquidation of the association, except that any such distribution shall be treated as made first out of the amount referred to in subparagraph (B), second out of the amount referred to in subparagraph (C), third out of the amount referred to in subparagraph (A), and then out of such other accounts as may be proper.

(2) AMOUNTS CHARGED TO RESERVE ACCOUNTS AND INCLUDED IN GROSS INCOME.—If any distribution is treated under paragraph (1) as having been made out of the reserves described in subparagraphs (B) and (C) of such paragraph, the amount charged against such reserve shall be the amount which, when reduced by the amount of tax imposed under this chapter and attributable to the inclusion of such amount in gross income, is equal to the amount of such distribution; and the amount so charged against such reserve shall be included in gross income of the taxpayer.

(3) SPECIAL RULES.—

(A) For purposes of paragraph (1) (B), additions to the reserve for losses on qualifying real property loans for the taxable year in which the distribution occurs shall be taken into account.

(B) For purposes of computing under this section the amount of a reasonable addition to the reserve for losses on qualifying real property loans for any taxable year, any amount charged during any year to such reserve pursuant to the provisions of paragraph (2) shall not be taken into account.

(b) FORECLOSURE ON PROPERTY SECURING LOANS.—Part II of subchapter H of chapter 1 (relating to mutual savings banks, etc.) is amended by adding at the end thereof the following new section:

SEC. 595. FORECLOSURE ON PROPERTY SECURITY LOANS.

(a) NONRECOGNITION OF GAIN OR LOSS AS A RESULT OF FORECLOSURE.—In the case of a creditor which is an organization described in section 593(a), no gain or loss shall be recognized, and no debt shall be considered as becoming worthless or partially worthless, as the result of such organization having bid in at foreclosure, or having otherwise reduced to ownership or possession by agreement or process of law, any property which was security for the payment of any indebtedness.

(b) CHARACTER OF PROPERTY.—For purposes of sections 166 and 1221, any property acquired in a transaction with respect to which gain or loss to an organization was not recognized by reason of subsection (a) shall be considered as property having the same characteristics as the indebtedness for which such

property was security. Any amount realized by such organization with respect to such property shall be treated for purposes of this chapter as a payment on account of such indebtedness, and any loss with respect thereto shall be treated as a bad debt to which the provisions of section 166 (relating to allowance of a deduction for bad debts) apply.

(c) Basis.—The basis of any property to which subsection (a) applies shall be the basis of the indebtedness for which such property was security (determined as of the date of the acquisition of such property), properly increased for costs of acquisition.

(d) Regulatory Authority.—The Secretary or his delegate shall prescribe such regulations as he may deem necessary to carry out the purposes of this section.

(c) Definition of Domestic Building and Loan Association.—Paragraph (19) of section 7701(a) (definition of domestic building and loan association) is amended to read as follows:

(19) Domestic building and loan association.—The term "domestic building and loan association" means a domestic building and loan association, a domestic savings and loan association, and a Federal savings and loan association—

(A) which either (i) is an insured institution within the meaning of section 401(a) of the National Housing Act (12 U.S.C., sec. 1724(a)), or (ii) is subject by law to supervision and examination by State or Federal authority having supervision over such associations;

(B) substantially all of the business of which consists of acquiring the savings of the public and investing in loans described in subparagraph (C);

(C) at least 90 percent of the amount of the total assets of which (as of the close of the taxable year) consists of (i) cash, (ii) obligations of the United States or of a State or political subdivision thereof, stock or obligations of a corporation which is an instrumentality of the United States or of a State or political subdivision thereof, and certificates of deposit in, or obligations of, a corporation organized under a State law which specifically authorizes such corporation to insure the deposits or share accounts of member associations, (iii) loans secured by an interest in real property and loans made for the improvement of real property, (iv) loans secured by a deposit or share of a member, (v) property acquired through the liquidation of defaulted loans described in clause (iii), and (vi) property used by the association in the conduct of the business described in subparagraph (B);

(D) of the assets of which taken into account under subparagraph (C) as assets constituting the 90 percent of total assets—

(i) at least 80 percent of the amount of such assets consists of assets described in clauses (i), (ii), (iv), and (vi) of such subparagraph and of loans secured by an interest in real property which is (or, from the proceeds of the loan, will become) residential real property or real property used primarily for church purposes, loans made for the improvement of residential real property or real property used primarily for church purposes, or property acquired through the liquidation of defaulted loans described in this clause; and

(ii) at least 60 percent of the amount of such assets consists of assets described in clauses (i), (ii), (iv), and (vi) of such subparagraph and of loans secured by an interest in real property which is (or, from the proceeds of the loan, will become) residential real property containing 4 or fewer family units or real property used primarily for church purposes, loans made for the improvement of residential real property containing 4 or fewer family units or real property used primarily for church purposes, or property acquired through the liquidation of defaulted loans described in this clause;

(E) not more than 18 percent of the amount of the total assets of which (as of the close of the taxable year) consists of assets other than

those described in clause (i) of subparagraph (D), and not more than 36 percent of the amount of the total assets of which (as of the close of the taxable year) consists of assets other than those described in clause (ii) of subparagraph (D); and

(F) except for property described in subparagraph (C), not more than 3 percent of the assets of which consists of stock of any corporation.

The term "domestic building and loan association" also includes any association which, for the taxable year, would satisfy the requirements of the first sentence of this paragraph if "41 percent" were substituted for "36 percent" in subparagraph (E). Except in the case of the taxpayer's first taxable year beginning after the date of the enactment of the Revenue Act of 1962, the second sentence of this paragraph shall not apply to an association for the taxable year unless such association (i) was a domestic building and loan association within the meaning of the first sentence of this paragraph for the first taxable year preceding the taxable year, or (ii) was a domestic building and loan association solely by reason of the second sentence of this paragraph for the first taxable year preceding the taxable year (but not for the second preceding taxable year). At the election of the taxpayer, the percentages specified in this paragraph shall be applied on the basis of the average assets outstanding during the taxable year, in lieu of the close of the taxable year, computed under regulations prescribed by the Secretary or his delegate.

(d) Clerical Amendments.—The table of sections for part II of subchapter H of chapter 1 is amended—

(1) by striking out the third item and inserting in lieu thereof the following:

Sec. 593. Reserves for losses on loans.

and

(2) by adding at the end thereof the following:

Sec. 595. Foreclosure on property securing loans.

(e) Repeal of Exemption From Certain Taxes.—(1) Amendment to home owners' loan act of 1933.—Section 5(h) of the Home Owners' Loan Act of 1933, as amended (12 U.S.C. sec. 1464(h)), is amended to read as follows:

(h) No State, county, municipal, or local taxing authority shall impose any tax on such associations or their franchise, capital, reserves, surplus, loans, or income greater than that imposed by such authority on other similar local mutual or cooperative thrift and home financing institutions.

(2) Certain documentary stamp taxes.—Section 4382(a)(2) (relating to exemptions from documentary stamp taxes) is amended to read as follows:

(2) Domestic building and loan associations and mutual ditch or irrigation companies.—Shares or certificates of stock issued by domestic building and loan associations and cooperative banks, to the extent such shares or certificates represent deposits or withdrawable accounts; or shares or certificates of stock and certificates of indebtedness issued by mutual ditch or irrigation companies.

(f) Deductions for Dividends or Interest Paid on Deposits.—Section 591 (relating to deduction for dividends paid on deposits) is amended—

(1) by striking out "and domestic building and loan associations" and inserting in lieu thereof the following: "domestic building and loan associations, and other savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law"; and

(2) by inserting after "dividends" the following: "or interest".

(g) Effective Dates.—

(1) The amendment made by subsection (a) shall apply to taxable years ending after December 31, 1962, except that section 593(f) of the Internal Revenue Code of 1954 shall apply to distributions after December 31, 1962, in taxable years ending after such date.

(2) The amendment made by subsection (b) shall apply to transactions described in section 595(a) of the Internal Revenue Code of 1954 occurring after December 31, 1962, in taxable years ending after such date.

(3) The amendment made by subsection (c) shall apply to taxable years beginning after the date of the enactment of this Act.

(4) Subsection (e) of this section shall become effective on January 1, 1963, except that—

(A) in the case of the tax imposed by section 4251 of the Internal Revenue Code of 1954, such subsection shall apply only with respect to amounts paid pursuant to bills rendered after December 31, 1962; and

(B) in the case of the tax imposed by section 4261 of such Code, such subsection shall apply only with respect to transportation beginning after December 31, 1962.

SEC. 7. DISTRIBUTIONS BY FOREIGN TRUSTS.

(a) Definitions.—

(1) Income of foreign trust.—Section 643(a)(6) (relating to modifications taken into account in computing distributable net income) is amended to read as follows:

(6) Income of foreign trust.—In the case of a foreign trust—

(A) There shall be included the amounts of gross income from sources without the United States, reduced by any amounts which would be deductible in respect of disbursements allocable to such income but for the provisions of section 265(1) (relating to disallowance of certain deductions).

(B) Gross income from sources within the United States shall be determined without regard to section 894 (relating to income exempt under treaty).

(C) Paragraph (3) shall not apply to a foreign trust created by a United States person. In the case of such a trust, (i) there shall be included gains from the sale or exchange of capital assets, reduced by losses from such sales or exchanges to the extent such losses do not exceed gains from such sales or exchanges, and (ii) the deduction under section 1202 (relating to deduction for excess of capital gains over capital losses) shall not be taken into account.

(2) Foreign trusts.—Section 643 (relating to definitions) is amended by adding at the end thereof the following new subsection:

(d) Foreign Trusts Created by United States Persons.—For purposes of this part, the term "foreign trust created by a United States person" means that portion of a foreign trust (as defined in section 7701(a)(31)) attributable to money or property transferred directly or indirectly by a United States person (as defined in section 7701(a)(30)), or under the will of a decedent who at the date of his death was a United States citizen or resident.

(b) Accumulation Distributions of Foreign Trusts.—

(1) Section 665(b) (relating to definitions applicable to subpart D) is amended by striking out "(b) Accumulation Distribution.—For purposes of this subpart," and inserting in lieu thereof the following:

(b) Accumulation Distributions of Trusts Other Than Certain Foreign Trusts.—For purposes of this subpart, in the case of a trust (other than a foreign trust created by a United States person).

(2) Section 665 is amended by redesignating subsections (c) and (d) as (d) and (e), respectively, and by inserting after subsection (b) the following new subsection:

(c) Accumulation Distribution of Certain Foreign Trusts.—For purposes of this subpart, in the case of a foreign trust created by a United States person, the term "accumulation distribution" for any taxable year of the trust means the amount by which the amounts specified in paragraph (2) of section 661(a) for such taxable year exceed distributable net income, reduced by the amounts specified in paragraph (1) of section 661(a). For purposes of this subsection, the amount specified in paragraph (2) of section 661(a) shall be determined without regard to section 666. Any amount paid to a United States person which is from a payor who is not a United States person and which is derived directly or indirectly from a foreign trust created by a United States person shall be deemed in the year of payment to have been directly paid by the foreign trust.

(c) Allocation of Accumulation Distributions to Preceding Years.—Section 666(a) (relating to accumulation distribution allocated to 5 preceding years) is amended—

(1) by striking out "(a) Amount Allocated.—In the case of a trust" and inserting in lieu thereof the following:

(a) Amount Allocated.—In the case of a trust (other than a foreign trust created by a United States person) ; and

(2) by adding at the end thereof the following new sentence:

(2) In the case of a foreign trust created by a United States person, this subsection shall apply to the preceding taxable years of the trust without regard to any provision of the preceding sentences which would (but for this sentence) limit its application to the 5 preceding taxable years.

(d) Amounts Treated as Received in Prior Years.—Section 668 (a) (relating to amounts treated as received in prior taxable years) is amended by adding at the end thereof the following new sentence:

Except as provided in section 669, in the case of a foreign trust created by a United States person the preceding sentence shall not apply to any beneficiary who is a United States person.

(e) Special Rules for Foreign Trusts.—Subpart D of part I of subchapter J of chapter 1 (relating to treatment of excess distributions by trusts) is amended by adding at the end thereof the following new section:

SEC. 669. SPECIAL RULES APPLICABLE TO CERTAIN FOREIGN TRUSTS.

(a) Limitation on Tax.—

(1) General rule.—At the election of a beneficiary who is a United States person (as defined in section 7701(a)(30) and who satisfies the requirements of subsection (b), the tax attributable to the amounts treated under section 668(a) as having been received by him from a foreign trust created by a United States person on the last day of a preceding taxable year of the trust shall not be greater than—

(A) the tax determined under the next to the last sentence of section 668(a), or

(B) the tax determined by multiplying by the number of preceding taxable years of the trust, on the last day of each of which an amount is deemed under section 666(a) to have been distributed, the average of the increase in tax attributable to recomputing the beneficiary's gross income for the taxable year and each of his 2 taxable years immediately preceding the year of the accumulation distribution by adding to the income of each of such years an amount determined by dividing the amount required to be included in income under section 668(a) by such number of preceding taxable years of the trust. The recomputation for the taxable year shall be made without regard to the inclusion in income required by section 668(a) of any amount other than pursuant to this paragraph.

(2) Exceptions.—

(A) When an accumulation distribution is deemed under section 666(a) to have been distributed on the last day of less than 3 taxable years of the trust, the taxable years of the beneficiary for which a recomputation is made under subsection (a)(1)(B) shall equal the number of years to which section 666(a) applies, commencing with the most recent taxable year of the beneficiary.

(B) If a beneficiary was not alive on the last day of each preceding taxable year of the trust with respect to which a distribution is deemed made under section 666(a), paragraph (1)(A) of this subsection shall not apply. In applying paragraph (1)(B) of this subsection, no recomputation shall be made for a beneficiary for a taxable year for which he was not alive; if he has no preceding taxable year, the recomputation shall be made on the basis of his taxable year without regard to the inclusion in income required by section 668(a) of any amount other than pursuant to paragraph (1)(B).

(3) Effect of prior election.—In computing the limitation on tax under paragraph (1) of this subsection for any beneficiary—

(A) Subsequent election under paragraph (1)(A).—If an election has been made under paragraph (1)(B) of this subsection, for purposes of a subsequent election under paragraph (1)(A) the income of any year with respect to which an amount is deemed distributed to a beneficiary under section 666(a) shall include amounts previously deemed distributed to such beneficiary for such year as a result of an accumulation distribution with respect to which an election under paragraph (1)(B) was made.

(B) Subsequent election under paragraph (1)(B).—If with respect to an accumulation distribution an election has been made under either paragraph (1)(A) or paragraph (1)(B) of this subsection, or the next to the last sentence of section 668(a) has applied, for purposes of a subsequent election under paragraph (1)(B) the number of preceding taxable years of the trust with respect to which an amount is deemed distributed to a beneficiary under section 666(a) shall be determined without regard to any such year with respect to which an amount was previously deemed distributed to such beneficiary.

(b) Information Requirement.—The election of a beneficiary to apply the limitations on tax provided in subsection (a) of this section shall not be effective unless the benficiary at the time of making the election supplies such information with respect to the operation and accounts of the trust, for each taxable year on the last day of which an amount is deemed distributed under section 666(a), as the Secretary or his delegate may by regulations prescribe.

(f) Information Returns With Respect to Foreign Trust.—Subpart B of part III of subchapter A of chapter 61 (relating to information concerning transactions with other persons) is amended by adding at the end thereof the following new section:

SEC. 6048. RETURNS AS TO CREATION OF OR TRANSFERS TO CERTAIN FOREIGN TRUSTS.

(a) General Rule.—On or before the 90th day after—

(1) the creation of any foreign trust by a United States person, or

(2) the transfer of any money or property to a foreign trust by a United States person,

the grantor in the case of an inter vivos trust, the fiduciary of an estate in the case of a testamentary trust, or the transferor, as the case may be, shall make a return in compliance with the provisions of subsection (b).

(b) FORM AND CONTENTS OF RETURNS.—The returns required by subsection (a) shall be in such form and shall set forth, in respect of the foreign trust, such information as the Secretary or his delegate prescribes by regulation as necessary for carrying out the provisions of the income tax laws.

(c) CROSS REFERENCES.—

(1) For provisions relating to penalties for violations of this section, see sections 6677 and 7203.

(2) For definition of the term "foreign trust created by a United States person", see section 643(d).

(g) FAILURE TO FILE INFORMATION RETURNS.—Subchaper B of chapter 68 (relating to assessable penalties) is amended by adding at the end thereof the following new section:

SEC. 6677. FAILURE TO FILE INFORMATION RETURNS WITH RESPECT TO CERTAIN FOREIGN TRUSTS.

(a) CIVIL PENALTY.—In addition to any criminal penalty provided by law, any person required to file a return under section 6048 who fails to file such return at the time provided in such section, or who files a return which does not show the information required pursuant to such section, shall pay a penalty equal to 5 percent of the amount transferred to a trust, but not more than $1,000, unless it is shown that such failure is due to reasonable cause.

(b) DEFICIENCY PROCEDURES NOT TO APPLY.—Subchapter B of chapter 63 (relating to deficiency procedures for income, estate, and gift taxes) shall not apply in respect of the assessment or collection of any penalty imposed by subsection (a).

(h) UNITED STATES PERSON DEFINED.—Section 7701(a) is amended by adding at the end thereof the following new paragraphs:

(30) UNITED STATES PERSON.—The term "United States person" means—

(A) a citizen or resident of the United States,

(B) a domestic partnership,

(C) a domestic corporation, and

(D) any estate or trust (other than a foreign estate or foreign trust, within the meaning of section 7701(a)(31)).

(31) FOREIGN ESTATE OR TRUST.—The terms "foreign estate" and "foreign trust" mean an estate or trust, as the case may be, the income of which from sources without the United States is not includible in gross income under subtitle A.

(i) TECHNICAL AMENDMENTS.—

(1) The table of sections for subpart D of subchapter J of chapter 1 (relating to treatment of excess distributions by trusts) is amended by adding at the end thereof

Sec. 669. Special rules applicable to certain foreign trusts.

(2) The table of sections for subpart B of part III of subchapter A of chapter 61 (relating to information concerning transactions with other persons) is amended by adding at the end thereof

Sec. 6048. Returns as to creation of or transfers to certain foreign trusts.

(3) The table of sections for subchapter B of chapter 68 (relating to assessable penalties) is amended by adding at the end thereof

Sec. 6677. Failure to file information returns with respect to certain foreign trusts.

(j) Effective Date.—The amendments made by this section (other than by subsections (f), (g), and (h)) shall apply with respect to distributions made after December 31, 1962.

SEC. 8. MUTUAL INSURANCE COMPANIES (OTHER THAN LIFE, MARINE, AND CERTAIN FIRE OR FLOOD INSURANCE COMPANIES), ETC.

(a) Imposition of Tax.—So much of part II of subchapter L (relating to mutual insurance companies, other than life or marine or fire insurance companies issuing perpetual policies) of chapter 1 as precedes section 822 is amended to read as follows:

PART II—MUTUAL INSURANCE COMPANIES (OTHER THAN LIFE AND CERTAIN MARINE INSURANCE COMPANIES AND OTHER THAN FIRE OR FLOOD INSURANCE COMPANIES WHICH OPERATE ON BASIS OF PERPETUAL POLICIES OR PREMIUM DEPOSITS)

Sec. 821. Tax on mutual insurance companies to which part II applies.
Sec. 822. Determination of taxable investment income.
Sec. 823. Determination of statutory underwriting income or loss.
Sec. 824. Adjustments to provide protection against losses.
Sec. 825. Unused loss deduction.
Sec. 826. Election by reciprocal.

SEC. 821. TAX ON MUTUAL INSURANCE COMPANIES TO WHICH PART II APPLIES.

(a) Imposition of Tax.—A tax is hereby imposed for each taxable year beginning after December 31, 1962. on the mutual insurance company taxable income of every mutual insurance company (other than a life insurance company and other than a fire, flood, or marine insurance company subject to the tax imposed by section 831). Such tax shall consist of—

(1) Normal tax.—

(A) Taxable years beginning before july 1, 1963.—In the case of taxable years beginning before July 1, 1963, a normal tax of 30 percent of the mutual insurance company taxable income, or 60 percent of the amount by which such taxable income exceeds $6,000, whichever is the lesser;

(B) Taxable years beginning after june 30, 1963.—In the case of taxable years beginning after June 30, 1963, a normal tax of 25 percent of the mutual insurance company taxable income, or 50 percent of the amount by which such taxable income exceeds $6,000, whichever is the lesser; plus

(2) Surtax.—A surtax of 22 percent of the mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) in excess of $25,000.

(b) Mutual Insurance Company Taxable Income Defined.—For purposes of this part, the term "mutual insurance company taxable income" means, with respect to any taxable year, the amount by which—

(1) the sum of—

(A) the taxable investment income (as defined in section 822(a)(1)).

(B) the statutory underwriting income (as defined in section 823(a)(1)), and

(C) the amounts required by section 824(d) to be subtracted from the protection against loss account, exceeds

(2) the sum of—

(A) the investment loss (as defined in section 822(a)(2)),

(B) the statutory underwriting loss (as defined in section 823(a)(2)), and

(C) the unused loss deduction provided by section 825(a).

(c) Alternative Tax for Certain Small Companies.—

(1) Imposition of tax.—In the case of taxable years beginning after December 31, 1962, there is hereby imposed for each taxable year on the

income of each mutual insurance company to which this subsection applies a tax (which shall be in lieu of the tax imposed by subsection (a)) computed as follows:

(A) NORMAL TAX.—

(i) TAXABLE YEARS BEGINNING BEFORE JULY 1, 1963.—In the case of taxable years beginning before July 1, 1963, a normal tax of 30 percent of the taxable investment income, or 60 percent of the amount by which such taxable income exceeds $3,000, whichever is the lesser;

(ii) TAXABLE YEARS BEGINNING AFTER JUNE 30, 1963.—In the case of taxable years beginning after June 30, 1963, a normal tax of 25 percent of the taxable investment income, or 50 percent of the amount by which such taxable income exceeds $3,000, whichever is the lesser; plus

(B) SURTAX.—A surtax of 22 percent of the taxable investment income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) in excess of $25,000.

(2) GROSS AMOUNT RECEIVED, OVER $150,000 BUT LESS THAN $250,000.—If the gross amount received during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) is over $150,000 but less than $250,000, the tax imposed by paragraph (1) shall be reduced to an amount which bears the same proportion to the amount of the tax determined under paragraph (1) as the excess over $150,000 of such gross amount received bears to $100,000.

(3) COMPANIES TO WHICH SUBSECTION APPLIES.—

(A) IN GENERAL.—Except as provided in subparagraph (B), this subsection shall apply to every mutual insurance company (other than a life insurance company and other than a fire, flood, or marine insurance company subject to the tax imposed by section 831) which received during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits. and assessments) a gross amount in excess of $150,000 but not in excess of $500,000.

(B) EXCEPTIONS.—This subsection shall not apply to a mutual insurance company for the taxable year if—

(i) there is in effect an election by such company made under subsection (d) to be taxable under subsection (a); or

(ii) there is any amount in the protection against loss account at the beginning of the taxable year.

(d) ELECTION TO INCLUDE STATUTORY UNDERWRITING INCOME OR LOSS.—

(1) IN GENERAL.—Any mutual insurance company which is subject to the tax imposed by subsection (c) may elect, in such manner and at such time as the Secretary or his delegate may by regulations prescribe, to be subject to the tax imposed by subsection (a).

(2) EFFECT OF ELECTION.—If an election is made under paragraph (1), the electing company shall be subject to the tax imposed by subsection (a) (and shall not be subject to the tax imposed by subsection (c)) for the first taxable year for which such election is made and for all taxable years thereafter unless the Secretary or his delegate consents to a revocation of such election.

(e) NO UNITED STATES INSURANCE BUSINESS.—Foreign mutual insurance companies (other than a life insurance company and other than a fire, flood, or marine insurance company subject to the tax imposed by section 831) not carrying on an insurance business within the United States shall not be subject to this part but shall be taxable as other foreign corporations.

(f) SPECIAL TRANSITIONAL UNDERWRITING LOSS.—

(1) COMPANIES TO WHICH SUBSECTION APPLIES.—This subsection shall apply to every mutual insurance company which has been subject to the tax imposed by this section (as in effect before the enactment of this subsection) for the 5 taxable years immediately preceding January 1, 1962, and has incurred an underwriting loss for each of such 5 taxable years.

(2) REDUCTION OF STATUTORY UNDERWRITING INCOME.—For purposes of this part, the statutory underwriting income of a company described in paragraph (1) for the taxable year shall be the statutory underwriting

income for the taxable year (determined without regard to this subsection) reduced by the amount by which—

(A) the sum of the underwriting losses of such company for the 5 taxable years immediately preceding January 1, 1962, exceeds

(B) the total amount by which the company's statutory underwriting income was reduced by reason of this subsection for prior taxable years.

(3) UNDERWRITING LOSS DEFINED.—For purposes of this subsection, the term "underwriting loss" means statutory underwriting loss, computed without any deduction under section 824(a) and without any deduction under section 832(c)(11).

(4) YEARS TO WHICH SUBSECTION APPLIES.—This subsection shall apply with respect to any taxable year beginning after December 31, 1962, and before January 1, 1968, for which the taxpayer is subject to the tax imposed by subsection (a).

(g) CROSS REFERENCES.—

(1) For exemption from tax of certain mutual insurance companies, see section 501(c)(15).

(2) For alternative tax in case of capital gains, see section 1201(a).

(b) TAXABLE INVESTMENT INCOME.—

(1) IN GENERAL.—Section 822 (relating to determination of mutual insurance company taxable income) is amended by striking out the heading and subsection (a) and inserting in lieu thereof the following:

SEC. 822. DETERIMINATION OF TAXABLE INVESTMENT INCOME.

(a) DEFINITIONS.—For purposes of this part—

(1) The term "taxable investment income" means the gross investment income, minus the deductions provided in subsection (c).

(2) The term "investment loss" means the amount by which the deductions provided in subsection (c) exceed the gross investment income.

(2) CONFORMING AMENDMENTS.—Subsections (c) and (e) of section 822 are each amended by striking out "mutual insurance company taxable income" each place it appears and inserting in lieu thereof "taxable investment income".

(3) DIVIDENDS RECEIVED DEDUCTION.—Section 822(c)(7) (relating to special deductions) is amended by adding at the end thereof the following new sentence: "In applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received) for purposes of this paragraph, the reference in such section to 'taxable income' shall be treated as a reference to 'taxable investment income'."

(4) REDESIGNATION OF SECTION 823.—Part II of subchapter L of chapter 1 is amended by striking out

SEC. 823. OTHER DEFINITIONS.

For purposes of this part—,

and inserting in lieu thereof (at the end of section 822) the following:

(f) DEFINITIONS.—For purposes of this part—.

(c) STATUTORY UNDERWRITING INCOME OR LOSS.—Part II of subchapter L of chapter 1 is amended by adding after section 822(f) (as redesignated by subsection (b)(4) of this section) the following new sections:

SEC. 823. DETERMINATION OF STATUTORY UNDERWRITING INCOME OR LOSS.

(a) IN GENERAL.—For purposes of this part—

(1) The term "statutory underwriting income" means the amount by which—

(A) the gross income which would be taken into account in computing taxable income under section 832 if the taxpayer were subject to the tax imposed by section 831, reduced by the gross investment income exceeds

(B) the sum of (i) the deductions which would be taken into account in computing taxable income if the taxpayer were subject to the tax imposed by section 831, reduced by the deductions provided in section 822(c), plus (ii) the deductions provided in subsection (c) and section 824(a).

(2) The term "statutory underwriting loss" means the excess of the amount referred to in paragraph (1)(B) over the amount referred to in paragraph (1)(A).

(b) Modifications.—In applying subsection (a)—

(1) Net operating loss deduction.—The deduction for net operating losses provided in section 172 shall not be allowed.

(2) Interinsurers.—In the case of a mutual insurance company which is an interinsurer or reciprocal underwriter—

(A) there shall be allowed as a deduction the increase for the taxable year in savings credited to subscriber accounts, or

(B) there shall be included as an item of gross income the decrease for the taxable year in savings credited to subscriber accounts.

For purposes of the preceding sentence, the term "savings credited to subscriber accounts" means such portion of the surplus as is credited to the individual accounts of subscribers before the 16th day of the third month following the close of the taxable year, but only if the company would be obligated to pay such amount promptly to such subscriber if he terminated his contract at the close of the company's taxable year. For purposes of determining his taxable income, the subscriber shall treat any such savings credited to his account as a dividend paid or declared.

(c) Special Deduction for Small Company Having Gross Amount of Less Than $1,100,000.—

(1) In general.—If the gross amount received during the taxable year by a taxpayer subject to the tax imposed by section 821(a) from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) does not equal or exceed $1,100,000, then in determining the statutory underwriting income or loss for the taxable year there shall be allowed an additional deduction of $6,000; except that if such gross amount exceeds $500,000, such additional deduction shall be equal to 1 percent of the amount by which $1,100,000 exceeds such gross amount.

(2) Limitation.—The amount of the deduction allowed under paragraph (1) shall not exceed the statutory underwriting income for the taxable year, computed without regard to any deduction under this subsection or section 824(a).

SEC. 824. ADJUSTMENTS TO PROVIDE PROTECTION AGAINST LOSSES.

(a) Allowance of Deduction.—

(1) In general.—In determining the statutory underwriting income or loss for any taxable year there shall be allowed as a deduction the sum of—

(A) an amount equal to 1 percent of the losses incurred during the taxable year (as determined under section 832(b)(5)), plus

(B) an amount equal to 25 percent of the underwriting gain for the taxable year, plus

(C) if the concentrated windstorm, etc., premium percentage for the taxable year exceeds 40 percent, an amount determined by applying so much of such percentage as exceeds 40 percent to the underwriting gain for the taxable year.

For purposes of this paragraph, the term "underwriting gain" means statutory underwriting income, computed without any deduction under this subsection.

(2) Special rule for companies having concentrated windstorm, etc., risks.—For purposes of paragraph (1)(C), the term "concentrated windstorm, etc., premium percentage" means, with respect to any taxable year, the percentage obtained by dividing—

(A) the amount of the premiums earned on insurance contracts during the taxable year (as defined in section 832(b)(4)), to the extent attributable to insuring against losses arising, either in any one State or within 200 miles of any fixed point selected by the taxpayer, from windstorm, hail, flood, earthquake, or similar hazards, by

(B) the amount of the premiums earned on insurance contracts during the taxable year (as so defined).

(b) Protection Against Loss Account.—Each insurance company subject to the tax imposed by section 821(a) for any taxable year shall, for purposes of this part, establish and maintain a protection against loss account.

(c) Additions to Account.—There shall be added to the protection against loss account for each taxable year an amount equal to the amount allowable as a deduction for the taxable year under subsection (a)(1).

(d) Subtractions.—

(1) Annual subtractions.—After applying subsection (c), there shall be subtracted for the taxable year from the protection against loss account—

(A) first, an amount equal to the excess (if any) of the deduction allowed under subsection (a) for the taxable year over the underwriting gain (within the meaning of subsection (a)(1)) for the taxable year,

(B) then, the amount (if any) by which—

(i) the sum of the investment loss for such year and the statutory underwriting loss (reduced by the amount referred to in subparagraph (A)) for such year, exceeds

(ii) the sum of the statutory underwriting income for such taxable year and the taxable investment income for such taxable year,

(C) next (in the order in which the losses occurred), amounts equal to the unused loss carryovers to such year,

(D) next, any amount remaining which was added to the account for the fifth preceding taxable year, minus one-half of the amount remaining in the account for such taxable year which was added by reason of subsection (a)(1)(B), and

(E) finally, the amount by which the total amount in the account exceeds whichever of the following is the greater:

(i) 10 percent of premiums earned on insurance contracts during the taxable year (as defined in section 832(b)(4)) less dividends to policyholders (as defined in section 832(c)(11)), or

(ii) the total amount in the account at the close of the preceding taxable year.

(2) Rules for ceiling on protection against loss account.—For purposes of paragraph (1)(E), the total amount in the account shall be determined—

(A) after the application of this section without regard to paragraph (1)(E), and

(B) without taking into consideration amounts remaining in the account which were added, with respect to all taxable years, by reason of subsection (a)(1)(C).

(3) Priorities.—The amounts required to be subtracted from the protection against loss account—

(A) under subparagraphs (A), (B), and (C) of paragraph (1) shall be subtracted—

(i) first (on a first-in, first-out, basis) from amounts in the account with respect to the five preceding taxable years and the taxable year, and

(ii) then from amounts in the account with respect to earlier years,

(B) under subparagraph (E) of paragraph (1) shall be subtracted only from amounts in the account with respect to the taxable year, and

(C) under paragraphs (A), (B), (C), and (E) of paragraph (1) shall, if the amount to be subtracted from the total amounts in the account with respect to any taxable year is less than such total, be subtracted from each of the amounts (referred to in subsection (a)(1)) in the account with respect to such year in the proportion which each bears to such total.

(4) Termination of taxability under section 821.—If the taxpayer is not subject to tax under section 821 for any taxable year, the entire amount in the account at the close of the preceding taxable year shall be subtracted from the account in such preceding taxable year.

(5) Election to subtract amount from account.—

(A) A taxpayer may elect for any taxable year for which it is subject to tax under section 821(a) to subtract from its protection against loss account any amount which, but for the application of this subparagraph, would be in such account as of the close of such taxable year.

(B) The election provided by subparagraph (A) for any taxable year shall be made (in such manner and in such form as the Secretary or his delegate may by regulations prescribe) after the close of such taxable year and not later than the time prescribed by law for filing the return (including extensions thereof) for the taxable year following such taxable year. Such an election, once made, may not be revoked.

SEC. 825. UNUSED LOSS DEDUCTION.

(a) Amount of Deduction.—For purposes of this part, the unused loss deduction for the taxable year shall be an amount equal to the unused loss carryovers or carrybacks to the taxable year.

(b) Unused Loss Defined.—For purposes of this part, the term "unused loss" means, with respect to any taxable year, the amount (if any) by which—

(1) the sum of the statutory underwriting loss and the investment loss, exceeds

(2) the sum of—

(A) the taxable investment income,

(B) the statutory underwriting income, and

(C) the amounts required by section 824(d) to be subtracted from the protection against loss account.

(c) Loss Year Defined.—For purposes of this part, the term "loss year" means, with respect to any company subject to the tax imposed by section 821(a), any taxable year in which the unused loss (as defined in subsection (b)) of such taxpayer is more than zero.

(d) Years to Which Carried.—The unused loss for any loss year shall be—

(1) an unused loss carryback to each of the 3 taxable years preceding the loss year, and

(2) an unused loss carryover to each of the 5 taxable years following the loss year.

(e) Amount of Carrybacks and Carryovers.—The entire amount of the unused loss for any loss year shall be carried to the earliest of the taxable years to which such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess (if any) of the amount of such loss over the sum of the offsets (as defined in subsection (f)) for each of the prior taxable years to which such loss may be carried.

(f) Offset Defined.—For purposes of subsection (e), the term "offset" means with respect to any taxable year (hereinafter referred to as the "offset year")—

(1) in the case of an unused loss carryback from the loss year to the offset year, the mutual insurance company taxable income for the offset year; or

(2) in the case of an unused loss carryover from the loss year to the offset year, an amount equal to the sum of—

"(A) the amount required to be subtracted from the protection against loss account under section 824(d)(1)(C) for the offset year, plus

"(B) the mutual insurance company taxable income for the offset year.

For purposes of paragraphs (1) and (2)(B), the mutual insurance company taxable income for the offset year shall be determined without regard to any unused loss carryback or carryover from the loss year or any taxable year thereafter.

(g) Limitations.—For purposes of this part, an unused loss shall not be carried—

(1) to or from any taxable year beginning before January 1, 1963,

(2) to or from any taxable year for which the insurance company is not subject to the tax imposed by section 821(a), nor

(3) to any taxable year if, between the loss year and such taxable year, there is an intervening taxable year for which the insurance company was not subject to the tax imposed by section 821(a).

SEC. 826. ELECTION BY RECIPROCAL.

(a) IN GENERAL.—Except as otherwise provided in this section, any mutual insurance company which is an interinsurer or reciprocal underwriter (hereinafter in this section referred to as a 'reciprocal') subject to the taxes imposed by section 821(a) may, under regulations prescribed by the Secretary or his delegate, elect to be subject to the limitation provided in subsection (b). Such election shall be effective for the taxable year for which made and for all succeeding taxable years, and shall not be revoked except with the consent of the Secretary or his delegate.

(b) LIMITATION.—The deduction for amounts paid or incurred in the taxable year to the attorney-in-fact by a reciprocal making the election provided in subsection (a) shall be limited to, but in no case increased by, the deductions of thhe attorney-in-fact allocable, in accordance with regulations prescribed by the Secretary or his delegate, to the income received by the attorney-in-fact from the reciprocal.

(c) EXCEPTION.—An election may not be made by a reciprocal under subsection (a) unless the attorney-in-fact of such reciprocal—

(1) is subject to the taxes imposed by section 11 (b) and (c);

(2) consents in such manner as the Secretary or his delegate shall prescribe by regulations to make available such information as may be required during the period in which the election provided in subsection (a) is in effect, under regulations prescribed by the Secretary or his delegate;

(3) reports the income received from the reciprocal and the deductions allocable thereto under the same method of accounting under which the reciprocal reports deductions for amounts paid to the attorney-in-fact; and

(4) files its return on the calendar year basis.

(d) SPECIAL RULE.—In applying section 824(d)(1)(D), any amount which was added to the protection against loss account by reason of an election under this section shall be treated as having been added by reason of section 824(a)(1)(A).

(e) CREDIT.—Any reciprocal electing to be subject to the limitation provided in subsection (b) shall be credited with so much of the tax paid by the attorney-in-fact as is attributable, under regulations prescribed by the Secretary or his delegate, to the income received by the attorney-in-fact from the reciprocal in such taxable year.

(f) SURTAX EXEMPTION DENIED.—Any increase in taxable income of a reciprocal attributable to the limitation provided in subsection (b) shall be taxed without regard to the surtax exemption provided in section 821(a)(2).

(g) ADJUSTMENT FOR REFUND.—If for any taxable year an attorney-in-fact is allowed a credit or refund for taxes paid with respect to which credit or refund to the reciprocal resulted under subsection (e), the taxes of such reciprocal for such taxable year shall be properly adjusted under regulations prescribed by the Secretary or his delegate.

(h) TAXES OF ATTORNEY-IN-FACT UNAFFECTED.—Nothing in this section shall increase or decrease the taxes imposed by this chapter on the income of the attorney-in-fact.

(d) EXEMPTION FROM TAX.—Section 501(c)(15) (relating to exemption from tax of certain mutual insurance companies) is amended by striking out "$75,000" and in lieu thereof inserting "$150,000".

(e) MUTUAL FIRE INSURANCE COMPANIES OPERATING ON BASIS OF PREMIUM DEPOSITS.—

(1) APPLICATION OF SECTION 831(a).—Section 831(a) (imposing a tax on certain mutual marine and fire insurance companies and on stock insurance companies which are not life insurance companies) is amended to read as follows:

(a) IMPOSITION OF TAX.—Taxes computed as provided in section 11 shall be imposed for each taxable year or the taxable income of—

(1) every insurance company (other than a life or mutual insurance company),

(2) every mutual marine insurance company, and

(3) every mutual fire or flood insurance company—

(A) exclusively issuing perpetual policies, or

(B) whose principal business is the issuance of policies for which the premium deposits are the same, regardless of the length of the term for which the policies are written, if the unabsorbed portion of such premium deposits not required for losses, expenses, or establishment of reserves is returned or credited to the policyholder on cancellation or expiration of the policy.

(2) Treatment of unabsorbed premium deposits.—Section 832(b) (4) (relating to definition of premiums earned) is amended by adding at the end thereof the following new sentence: "For purposes of this subsection, unearned premiums of mutual fire or flood insurance companies described in section 831(a) (3) (B) means (with respect to the policies described in section 831(a) (3) (B)) the amount of unabsorbed premium deposits which the company would be obligated to return to its policyholders at the close of the taxable year if all of its policies were terminated at such time; and the determination of such amount shall be based on the schedule of unabsorbed premium deposit returns for each such company then in effect. Premiums paid by the subscriber of a mutual flood insurance company referred to in paragraph (3) of section 831(a) shall be treated, for purposes of computing the taxable income of such subscriber, in the same manner as premiums paid by a policyholder to a mutual fire insurance company referred to in such paragraph (3)."

(3) Conforming amendment.—Section 832(b) (1) (C) is amended by striking out "section 831(a)," and inserting in lieu thereof "section 831(a) (3) (A),".

(4) Adjustment of premium deposit.—Section 832(c) (11) is amended to read as follows:

(11) dividends and similar distributions paid or declared to policyholders in their capacity as such, except in the case of a mutual fire insurance company described in section 831(a) (3) (A). For purposes of the preceding sentence, the term "dividends and similar distributions" includes amounts returned or credited to policyholders on cancellation or expiration of policies described in section 831(a) (3) (B). For purposes of this paragraph, the term "paid or declared" shall be construed according to the method of accounting regularly employed in keeping the books of the insurance company; and.

(5) Additional item of income.—Section 832(b) (1) is amended by striking out "and" at the end of subparagraph (B), by striking out the period at the end of subparagraph (C) and inserting in lieu thereof ", and", and by adding at the end thereof the following new subparagraph:

(D) in the case of a mutual fire or flood insurance company described in section 831(a) (3) (B), an amount equal to 2 percent of the premiums earned on insurance contracts during the taxable year with respect to policies described in section 831(a) (3) (B) after deduction of premium deposits returned or credited during the same taxable year.

(f) ELECTION OF CERTAIN MUTUAL COMPANIES TO BE TAXED ON TOTAL INCOME.—Section 831 is amended by redesignating subsection (c) as subsection (d), and by inserting after subsection (b) the following new subsection:

(c) ELECTION FOR MULTIPLE LINE COMPANY TO BE TAXED ON TOTAL INCOME.—

(1) IN GENERAL.—Any mutual insurance company engaged in writing marine, fire, and casualty insurance which for any 5-year period beginning after December 31, 1941, and ending before January 1, 1962, was subject to the tax imposed by section 831 (or the tax imposed by corresponding provisions of prior law) may elect, in such manner and at such time as the Secretary or his delegate may by regulations prescribe, to be subject to the tax imposed by section 831, whether or not marine insurance is its predominant source of premium income.

(2) EFFECT OF ELECTION.—If an election is made under paragraph (1), the electing company shall (in lieu of being subject to the tax imposed by section 821) be subject to the tax imposed by this section for taxable years beginning after December 31, 1961. Such election shall not be revoked except with the consent of the Secretary or his delegate.

(g) TECHNICAL AMENDMENTS, ETC.

(1) CREDIT FOR FOREIGN TAXES.—Section 841 (relating to credit for foreign taxes) is amended by striking out "and" at the end of paragraph (1), by renumbering paragraph (2) as paragraph (3), and by inserting after paragraph (1) the following new paragraph:

(2) in the case of the tax imposed by section 821(a), the mutual insurance company taxable income (as defined in section 821(b)); and in the case of the tax imposed by section 821(c), the taxable investment income (as defined in section 822(a)), and.

(2) ADJUSTMENTS TO BASIS FOR DEPRECIATION SUSTAINED.—Section 1016(a)(3) (relating to adjustments to basis for depreciation, etc., sustained) is amended by striking out "and" at the end of subparagraph (B), by inserting "and" at the end of subparagraph (C), and by inserting after subparagraph (C) the following new subparagraph:

(D) since February 28, 1913, during which such property was held by a person subject to tax under part II of subchapter L (or the corresponding provisions of prior income tax laws), to the extent that paragraph (2) does not apply,.

(3) ALTERNATIVE TAX ON CAPITAL GAINS.—Section 1201(a) (relating to alternative tax on corporations) is amended by striking out "821 (a) (1) or (b)," and inserting in lieu thereof "821 (a) or (c),".

(4) CLERICAL AMENDMENTS.—

(A) The table of parts for subchapter L is amended by striking out the portion referring to part II and inserting in lieu thereof the following:

Part II. Mutual insurance companies (other than life and certain marine insurance companies and other than fire or flood insurance companies which operate on basis of perpetual policies or premium deposits.

(B) The heading to section 831 is amended to read as follows:

SEC. 831. TAX ON INSURANCE COMPANIES (OTHER THAN LIFE OR MUTUAL), MUTUAL MARINE INSURANCE COMPANIES, AND CERTAIN MUTUAL FIRE OR FLOOD INSURANCE COMPANIES.

(C) The Table of sections for part III of subchapter L is amended by striking out the portion referring to section 831 and inserting in lieu thereof the following:

Sec. 831. Tax on insurance companies (other than life or mutual), mutual marine insurance companies, and certain mutual fire or flood insurance companies.

(h) EFFECTIVE DATE.—The amendments made by this section (other than by subsection (f)) shall apply with respect to taxable years beginning after December 31, 1962.

SEC. 9. DOMESTIC CORPORATIONS RECEIVING DIVIDENDS FROM FOREIGN CORPORATIONS.

(a) FOREIGN TAXES DEEMED PAID BY DOMESTIC CORPORATIONS.—Section 902 (relating to credit for corporate stockholder in foreign corporations) is amended to read as follows:

SEC. 902. CREDIT FOR CORPORATE STOCKHOLDER IN FOREIGN CORPORATION.

(a) TREATMENT OF TAXES PAID BY FOREIGN CORPORATION.—For purposes of this subpart, a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall—

(1) to the extent such dividends are paid by such foreign corporation out of accumulated profits (as defined in subsection (c)(1)(A) of a year for which such foreign corporation is not a less developed country corporation, be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid or deemed to be paid by such foreign corporation to any foreign country or to any possession of the United States on or with respect to such accumulated profits, which the amount of such dividends (determined without regard to section 78) bears to the amount of such accumulated profits in excess of such income, war profits, and excess profits taxes (other than those deemed paid); and

(2) to the extent such dividends are paid by such foreign corporation out of accumulated profits (as defined in subsection (c)(1)(B)) of a year for which such foreign corporation is a less developed country corporation, be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid or deemed to be paid by such foreign corporation to any foreign country or to any possession of the United States on or with respect to such accumulated profits, which the amount of such dividends bears to the amount of such accumulated profits.

(b) FOREIGN SUBSIDIARY OF FOREIGN CORPORATION.—If such foreign corporation owns 50 percent or more of the voting stock of another foreign corporation from which it receives dividends in any taxable year, it shall be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid by such other foreign corporation to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of the corporation from which such dividends were paid which—

(1) for purposes of applying subsection (a)(1), the amount of such dividends bears to the amount of the accumulated profits (as defined in subsection (c)(1)(A)) of such other foreign corporation from which such dividends were paid in excess of such income, war profits, and excess profits taxes, or

(2) for purposes of applying subsection (a)(2), the amount of such dividends bears to the amount of the accumulated profits (as defined in subsection (c)(1)(B)) of such other foreign corporation from which such dividends were paid.

(c) APPLICABLE RULES.—

(1) ACCUMULATED PROFITS DEFINED.—For purposes of this section, the term "accumulated profits" means with respect to any foreign corporation—

(A) for purposes of subsections (a)(1) and (b)(1), the amount of its gains, profits, or income computed without reduction by the amount of the income, war profits, and excess profits taxes imposed on or with

respect to such profits or income by any foreign country or any possession of the United States; and

(B) for purposes of subsections (a)(2) and (b)(2), the amount of its gains, profits, or income in excess of the income, war profits, and excess profits taxes imposed on or with respect to such profits or income.

The Secretary or his delegate shall have full power to determine from the accumulated profits of what year or years such dividends were paid, treating dividends paid in the first 60 days of any year as having been paid from the accumulated profits of the preceding year or years (unless to his satisfaction shown otherwise), and in other respects treating dividends as having been paid from the most recently accumulated gains, profits, or earnings.

(2) Accounting periods.—In the case of a foreign corporation, the income, war profits, and excess profits taxes of which are determined on the basis of an accounting period of less than 1 year, the word "year" as used in this subsection shall be construed to mean such accounting period.

(d) Less Developed Country Corporation Defined.—For purposes of this section, the term "less developed country corporation" means—

(1) a foreign corporation which, for its taxable year, is a less developed country corporation within the meaning of section 955(c) (1) or (2), and

(2) a foreign corporation which owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote of a foreign corporation which is a less developed country corporation within the meaning of section 955(c)(1), and—

(A) 80 percent or more of the gross income of which for its taxable year meets the requirement of section 955(c)(1)(A); and

(B) 80 percent or more in value of the assets of which on each day of such year consists of property described in section 955(c)(1)(B).

A foreign corporation which is a less developed country corporation for its first taxable year beginning after December 31, 1962, shall, for purposes of this section, be treated as having been a less developed country corporation for each of its taxable years beginning before January 1, 1963.

(e) Cross References.—

(1) For inclusion in gross income of an amount equal to taxes deemed paid under subsection (a)(1), see section 78.

(2) For application of subsections (a) and (b) with respect to taxes deemed paid in a prior taxable year by a United States shareholder with respect to a controlled foreign corporation, see section 960.

(3) For reduction of credit with respect to dividends paid out of accumulated profits for years for which certain information is not furnished, see section 6038.

(b) Inclusion in Gross Income of Amount Equal to Taxes Deemed Paid.—Part II of subchapter B of chapter 1 (relating to items specifically included in gross income) is amended by adding at the end thereof the following new section:

SEC. 78. DIVIDENDS RECEIVED FROM CERTAIN FOREIGN CORPORATIONS BY DOMESTIC CORPORATIONS CHOOSING FOREIGN TAX CREDIT.

If a domestic corporation chooses to have the benefits of subpart A of part III of subchapter N (relating to foreign tax credit) for any taxable year, an amount equal to the taxes deemed to be paid by such corporation under section 902(a)(1) (relating to credit for corporate stockholder in foreign corporation) or under section 960(a)(1)(C) (relating to taxes paid by foreign corporation) for such taxable year shall be treated for purposes of this title (other than section 245) as a dividend received by such domestic corporation from the foreign corporation.

(c) Determination of Source of Dividends Received From Certain Foreign Corporations.—Section 861(a)(2)(B) (relating to dividends from foreign corporations treated as income from sources within the United States) is amended by striking out "to the extent exceeding the amount of the deduction allowable under section 245 in respect of such dividends" and inserting in lieu thereof "to the

extent exceeding the amount which is 100/85ths of the amount of the deduction allowable under section 245 in respect of such dividends".

(d) TECHNICAL AMENDMENTS.—

(1) The table of sections for part II of subchapter B of chapter 1 is amended by adding at the end thereof the following:

Sec. 78. Dividends received from certain foreign corporations by domestic corporations choosing foreign tax credit.

(2) Section 535(b)(1) and the first sentence of section 545(b)(1) are each amended by striking out "accrued during the taxable year," and inserting in lieu thereof "accrued during the taxable year or deemed to be paid by a domestic corporation under section 902(a)(1) or 960(a)(C) for the taxable year,".

(3) Section 901(d) is amended by adding the following new paragraph:

(4) For reduction of credit for failure of a United States person to furnish certain information with respect to a foreign corporation controlled by him, see section 6038.

(e) EFFECTIVE DATE.—The amendments made by this section shall apply—

(1) in respect of any distribution received by a domestic corporation after December 31,1964, and

(2) in respect of any distribution received by a domestic corporation before January 1, 1965, in a taxable year of such corporation beginning after December 31, 1962, but only to the extent that such distribution is made out of the accumulated profits of a foreign corporation for a taxable year (of such foreign corporation) beginning after December 31, 1962.

For purposes of paragraph (2), a distribution made by a foreign corporation out of its profits which are attributable to a distribution received from a foreign subsidiary to which section 902(b) applies shall be treated as made out of the accumulated profits of a foreign corporation for a taxable year beginning before January 1, 1963, to the extent that such distribution was paid out of the accumulated profits of such foreign subsidiary for a taxable year beginning before January 1, 1963.

SEC. 10. SEPARATE LIMITATION ON FOREIGN TAX CREDIT WITH RESPECT TO CERTAIN INTEREST INCOME.

(a) LIMITATION ON FOREIGN TAX CREDIT.—Section 904 (relating to limitations on foreign tax credit) is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

(f) APPLICATION OF SECTION IN CASE OF CERTAIN INTEREST INCOME.—

(1) IN GENERAL.—The provisions of subsections (a), (c), (d), and (e) of this section shall be applied separately with respect to—

(A) the interest income described in paragraph (2), and

(B) income other than the interest income described in paragraph (2).

(2) INTEREST INCOME TO WHICH APPLICABLE.—For purposes of this subsection, the interest income described in this paragraph is interest other than interest—

(A) derived from any transaction which is directly related to the active conduct of a trade or business in a foreign country or a possession of the United States,

(B) derived in the conduct of a banking, financing, or similar business,

(C) received from a corporation in which the taxpayer owns at least 10 percent of the voting stock, or

(D) received on obligations acquired as a result of the disposition of a trade or business actively conducted by the taxpayer in a foreign country or possession of the United States or as a result of the disposition of stock or obligations of a corporation in which the taxpayer owned at least 10 percent of the voting stock.

(3) Overall limitation not to apply.—The limitation provided by subsection (a)(2) shall not apply with respect to the interest income described in paragraph (2). The Secretary or his delegate shall by regulations prescribe the manner of application of subsection (e) with respect to cases in which the limitation provided by subsection (a)(2) applies with respect to income other than the interest income described in paragraph (2).

(4) Transitional rules for carrybacks and carryovers.—

(A) Carrybacks to years prior to revenue act of 1962.—Where, under the provisions of subsection (d), taxes (i) paid or accrued to any foreign country or possession of the United States in any taxable year beginning after the date of the enactment of the Revenue Act of 1962 are deemed (ii) paid or accrued in one or more taxable years beginning on or before the date of enactment of the Revenue Act of 1962, the amount of such taxes deemed paid or accrued shall be determined without regard to the provisions of this subsection. To the extent the taxes paid or accrued to a foreign country or possession of the United States in any taxable year described in clause (i) are not, with the application of the preceding sentence, deemed paid or accrued in any taxable year described in clause (ii), such taxes shall, for purposes of applying subsection (d), be deemed paid or accrued in a taxable year beginning after the date of the enactment of the Revenue Act of 1962, with respect to interest income described in paragraph (2), and with respect to income other than interest income described in paragraph (2), in the same ratios as the amount of such taxes paid or accrued with respect to interest income described in paragraph (2), and the amount of such taxes paid or accrued with respect to income other than interest income described in paragraph (2), respectively, bear to the total amount of such taxes paid or accrued to such foreign country or possession of the United States.

(B) Carryovers to years after revenue act of 1962.—Where, under the provisions of subsection (d), taxes (i) paid or accrued to any foreign country or possession of the United State in any taxable year beginning on or before the date of the enactment of the Revenue Act of 1962 are deemed (ii) paid or accrued in one or more taxable years beginning after the date of the enactment of the Revenue Act of 1962, the amount of such taxes deemed paid or accrued in any year described in clause (ii) shall, with respect to interest income described in paragraph (2), be an amount which bears the same ratio to the amount of such taxes deemed paid or accrued as the amount of the taxes paid or accrued to such foreign country or possession for such year with respect to interest income described in paragraph (2) bears to the total amount of the taxes paid or accrued to such foreign country or possession for such year; and the amount of such taxes deemed paid or accrued in any year described in clause (ii) with respect to income other than interest income described in paragraph (2) shall be an amount which bears the same ratio to the amount of such taxes deemed paid or accrued for such year as the amount of taxes paid or accrued to such foreign country or possession for such year with respect to income other than interest income described in paragraph (2) bears to the total amount of the taxes paid or accrued to such foreign country or possession for such year.

(b) Effective Date.—The amendments made by subsection (a) shall apply with respect to taxable years beginning after the date of the enactment of this Act, but only with respect to interest resulting from transactions consummated after April 2, 1962.

SEC. 11. EARNED INCOME FROM SOURCES WITHOUT THE UNITED STATES.

(a) Limitation on Amount and Type of Income Excluded.—Section 911 (relating to earned income from sources without the United States) is amended to read as follows:

SEC. 911. EARNED INCOME FROM SOURCES WITHOUT THE UNITED STATES.

(a) General Rule.—The following items shall not be included in gross income and shall be exempt from taxation under this subtitle:

(1) Bona fide resident of foreign country.—In the case of an individual citizen of the United States who establishes to the satisfaction of the Secretary or his delegate that he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) which constitute earned income attributable to services performed during such uninterrupted period. The amount excluded under this paragraph for any taxable year shall be computed by applying the special rules contained in subsection (c).

(2) Presence in foreign country for 17 months.—In the case of an individual citizen of the United States who during any period of 18 consecutive months is present in a foreign country or countries during at least 510 full days in such period, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) which constitute earned income attributable to services performed during such 18-month period. The amount excluded under this paragraph for any taxable year shall be computed by applying the special rules contained in subsection (c).

An individual shall not be allowed, as a deduction from his gross income, any deductions (other than those allowed by section 151, relating to personal exemptions) properly allocable to or chargeable against amounts excluded from gross income under this subsection.

(b) Definition of Earned Income.—For purposes of this section, the term "earned income" means wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered. In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, under regulations prescribed by the Secretary or his delegate, a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 30 percent of his share of the net profits of such trade or business, shall be considered as earned income.

(c) Special Rules.—For purposes of computing the amount excludable under subsection (a), the following rules shall apply:

(1) Limitations on amount of exclusion.—The amount excluded from the gross income of an individual under subsection (a) for any taxable year shall not exceed an amount which shall be computed on a daily basis at an annual rate of—

(A) except as provided in subparagraph (B), $20,000 in the case of an individual who qualifies under subsection (a), or

(B) $35,000 in the case of an individual who qualifies under subsection (a)(1), but only with respect to that portion of such taxable year occurring after such individual has been a bona fide resident of a foreign country or countries for an uninterrupted period of 3 consecutive years.

(2) Attribution to year in which services are performed.—For purposes of applying paragraph (1), amounts received shall be considered received in the taxable year in which the services to which the amounts are attributable are performed.

(3) Treatment of community income.—In applying paragraph (1) with respect to amounts received for services performed by a husband or wife which are community income under community property laws applicable to such income, the aggregate amount excludable under subsection (a) from the

gross income of such husband and wife shall equal the amount which would be excludable if such amounts did not constitute such community income.

(4) Requirement as to time of receipt.—No amount received after the close of the taxable year following the taxable year in which the services to which the amounts are attributable are performed may be excluded under subsection (a).

(5) Certain amounts not excludable.—No amount—

(A) received as a pension or annuity, or

(B) included in gross income by reason of section 402(b) (relating to taxability of beneficiary of non-exempt trust), section 403(c) (relating to taxability of beneficiary under a non-qualified annuity), or section 403(d) (relating to taxability of beneficiary under certain forfeitable contracts purchased by exempt organizations),

may be excluded under subsection (a).

(6) Test of bona fide residence.—A statement by an individual who has earned income from sources within a foreign country to the authorities of that country that he is not a resident of that country, if he is held not subject as a resident of that country to the income tax of that country by its authorities with respect to such earnings, shall be conclusive evidence with respect to such earnings that he is not a bona fide resident of that country for purposes of subsection (a) (1).

(7) Certain noncash remuneration.—If an individual who qualifies under subsection (a) (1) receives compensation from sources without the United States (except from the United States or any agency thereof) in the form of the right to use property or facilities, the limitation under paragraph (1) applicable with respect to such individual—

(A) for a taxable year ending in 1963 shall be increased by an amount equal to the amount of such compensation so received during such taxable year;

(B) for a taxable year ending in 1964, shall be increased by an amount equal to two-thirds of such compensation so received during such taxable year; and

(C) for a taxable year ending in 1965, shall be increased by an amount equal to one-third of such compensation so received during such taxable year.

(d) Cross References.—For administrative and penal provisions relating to the exclusion provided for in this section, see sections 6001, 6011, 6012(c), and the other provisions of subtitle F.

(b) Computation of Employees' Contributions.—Section 72(f) (relating to special rules for computing employees' contributions) is amended by adding after paragraph (2) the following new sentences: "Paragraph (2) shall not apply to amounts which were contributed by the employer after December 31, 1962, and which would not have been includible in the gross income of the employee by reason of the application of section 911 if such amounts had been paid directly to the employee at the time of contribution. The preceding sentence shall not apply to amounts which were contributed by the employer, as determined under regulations prescribed by the Secretary or his delegate, to provide pension or annuity credits, to the extent such credits are attributable to services performed before January 1, 1963, and are provided pursuant to pension or annuity plan provisions in existence on March 12, 1962, and on that date applicable to such services.

(c) Effective Dates.—

(1) Amendment to section 911.—The amendment made by subsection (a) shall apply to taxable years ending after September 4, 1962, but only with respect to amounts—

(A) received after March 12, 1962, which are attributable to services performed after December 31, 1962, or

(B) received after December 31, 1962, which are attributable to services performed on or before December 31, 1962, unless on March 12, 1962, there existed a right (whether forfeitable or nonforfeitable) to receive such amounts.

(2) AMENDMENT TO SECTION 72(f).—The amendment made by subsection (b) shall apply to taxable years ending after December 31, 1962.

SEC. 12. CONTROLLED FOREIGN CORPORATIONS.

(a) IN GENERAL.—Part III of subchapter N of chapter 1 (relating to income from sources without the United States) is amended by adding at the end thereof the following new subparts:

Subpart F—Controlled Foreign Corporations

SEC. 951. AMOUNTS INCLUDED IN GROSS INCOME OF UNITED STATES SHAREHOLDERS.

(a) AMOUNTS INCLUDED.—

(1) IN GENERAL.—If a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year beginning after December 31, 1962, every person who is a United States shareholder (as defined in subsection (b)) of such corporation and who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends—

(A) the sum of—

(i) except as provided in section 963, his pro rata share (determined under paragraph (2)) of the corporation's subpart F income for such year, and

(ii) his pro rata share (determined under section 955(a)(3)) of the corporation's previously excluded subpart F income withdrawn from investment in less developed countries for such year; and

(B) his pro rata share (determined under section 956(a)(2)) of the corporation's increase in earnings invested in United States property for such year (but only to the extent not excluded from gross income under section 959(a)(2)).

(2) PRO RATA SHARE OF SUBPART F INCOME.—The pro rata share referred to in paragraph (1)(A)(i) in the case of any United States shareholders is the amount—

(A) which would have been distributed with respect to the stock which such shareholder owns (within the meaning of section 958(a))

in such corporation if on the last day, in its taxable year, on which the corporation is a controlled foreign corporation it had distributed pro rata to its shareholders an amount (i) which bears the same ratio to its subpart F income for the taxable year, as (ii) the part of such year during which the corporation is a controlled foreign corporation bears to the entire year, reduced by

(B) the amount of distributions received by any other person during such year as a dividend with respect to such stock, but only to the extent of the dividend which would have been received if the distribution by the corporation had been the amount (i) which bears the same ratio to the subpart F income of such corporation for the taxable year, as (ii) the part of such year during which such shareholder did not own (within the meaning of section 958(a) such stock bears to the entire year.

(3) LIMITATION ON PRO RATA SHARE OF PREVIOUSLY EXCLUDED SUBPART F INCOME WITHDRAWN FROM INVESTMENT.—For purposes of paragraph (1)(A)(ii), the pro rata share of any United States shareholder of the previously excluded subpart F income of a controlled foreign corporation withdrawn from investment in less developed countries shall not exceed an amount (A) which bears the same ratio to his pro rata share of such income withdrawn (as determined under section 955(a)(3)) for the taxable year, as (B) the part of such year during which the corporation is a controlled foreign corporation bears to the entire year.

(4) LIMITATION ON PRO RATA SHARE OF INVESTMENT IN UNITED STATES PROPERTY.—For purposes of paragraph (1)(B), the pro rata share of any United States shareholder in the increase of the earnings of a controlled foreign corporation invested in United States property shall not exceed an amount (A) which bears the same ratio to his pro rata share of such increase (as determined under section 956(a)(2)) for the taxable year, as (B) the part of such year during which the corporation is a controlled foreign corporation bears to the entire year.

(b) UNITED STATES SHAREHOLDER DEFINED.—For purposes of this subpart, the term "United States shareholder" means, with respect to any foreign corporation, a United States person (as defined in section 957(d)) who owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.

(c) COORDINATION WITH ELECTION OF A FOREIGN INVESTMENT COMPANY TO DISTRIBUTE INCOME.—A United States shareholder who, for his taxable year, is a qualified shareholder (within the meaning of section 1247(c)) of a foreign investment company with respect to which an election under section 1247 is in effect shall not be required to include in gross income, for such taxable year, any amount under subsection (a) with respect to such company.

(d) COORDINATION WITH FOREIGN PERSONAL HOLDING COMPANY PROVISIONS.—A United States shareholder who, for his taxable year, is subject to tax under section 551(b) (relating to foreign personal holding company income included in gross income of United States shareholders) on income of a controlled foreign corporation shall not be required to include in gross income, for such taxable year, any amount under subsection (a) with respect to such company.

SEC. 952. SUBPART F INCOME DEFINED.

(a) IN GENERAL.—For purposes of this subpart, the term "subpart F income" means, in the case of any controlled foreign corporation, the sum of—

(1) the income derived from the insurance of United States risks (as determined under section 953), and

(2) the foreign base company income (as determined under section 954).

(b) EXCLUSION OF UNITED STATES INCOME.—Subpart F income does not include any item includible in gross income under this chapter (other than this subpart) as income derived from sources within the United States of a foreign corporation engaged in trade or business in the United States.

(c) LIMITATION.—For purposes of subsection (a), the subpart F income of any controlled foreign corporation for any taxable year shall not exceed the earnings and profits of such corporation for such year reduced by the amount (if any) by which—

(1) an amount equal to—

(A) the sum of the deficits in earnings and profits for prior taxable years beginning after December 31, 1962, plus

(B) the sum of the deficits in earnings and profits for taxable years beginning after December 31, 1959, and before January 1, 1963 (reduced by the sum of the earnings and profits for such taxable years); exceeds

(2) an amount equal to the sum of the earnings and profits for prior taxable years beginning after December 31, 1962, allocated to other earnings and profits under section 959(c)(3).

For purposes of the preceding sentence, any deficit in earnings and profits for any prior taxable year shall be taken into account under paragraph (1) for any taxable year only to the extent it has not been taken into account under such paragraph for any preceding taxable year to reduce earnings and profits of such preceding year.

(d) Special Rule in Case of Indirect Ownership.—For purposes of subsection (c), if—

(1) a United States shareholder owns (within the meaning of section 958(a)) stock of a foreign corporation, and by reason of such ownership owns (within the meaning of such section) stock of any other foreign corporation, and

(2) any of such foreign corporations has a deficit in earnings and profits for the taxable year.

then the earnings and profits for the taxable year of each such foreign corporation which is a controlled foreign corporation shall, with respect to such United States shareholder, be properly reduced to take into account any deficit described in paragraph (2) in such manner as the Secretary or his delegate shall prescribe by regulations.

SEC. 953. INCOME FROM INSURANCE OF UNITED STATES RISKS.

(a) General Rule.—For purposes of section 952(a)(1), the term "income derived from the insurance of United States risks" means that income which—

(1) is attributable to the reinsurance or the issuing of any insurance or annuity contract—

(A) in connection with property in, or liability arising out of activity in, or in connection with the lives or health of residents of, the United States, or

(B) in connection with risks not included in subparagraph (A) as the result of any arrangement whereby another corporation receives a substantially equal amount of premiums or other consideration in respect to any reinsurance or the issuing of any insurance or annuity contract in connection with property in, or liability arising out of activity in, or in connection with the lives or health of residents of, the United States, and

(2) would (subject to the modifications provided by paragraphs (1), (2), and (3) of subsection (b)) be taxed under subchapter L of this chapter if such income were the income of a domestic insurance corporation.

This section shall apply only in the case of a controlled foreign corporation which receives, during any taxable year, premiums or other consideration in respect of the reinsurance, and the issuing, of insurance and annuity contracts described in paragraph (1) in excess of 5 percent of the total of premiums and other consideration received during such taxable year in respect of all reinsurance and issuing of insurance and annuity contracts.

(b) Special Rules.—For purposes of subsection (a)—

(1) In the application of part I of subchapter L, life insurance company taxable income is the gain from operations as defined in section 809(b).

(2) A corporation which, would, if it were a domestic insurance corporation, be taxable under part II of subchapter L shall apply subsection (a) as if it were taxable under part III of subchapter L.

(3) The following provisions of subchapter L shall not apply:

(A) Section 809(d)(4) (operations loss deduction).

(B) Section 809(d)(5) (certain nonparticipating contracts).

(C) Section 809(d)(6) (group life, accident, and health insurance).

(D) Section 809(d)(10) (small business deduction).

(E) Section 817(b) (gain on property held on December 31, 1958, and certain substituted property acquired after 1958).

(F) Section 832(b)(5) (certain capital losses).

(4) The items referred to in—

(A) section 809(c)(1) (relating to gross amount of premiums and other considerations),

(B) section 809(c)(2) (relating to net decrease in reserves),

(C) section 809(d)(2) (relating to net increase in reserves), and

(D) section 832(b)(4) (relating to premiums earned on insurance contracts),

shall be taken into account only to the extent they are in respect of any reinsurance or the issuing of any insurance or annuity contract described in subsection (a)(1).

(5) All items of income, expenses, losses, and deductions (other than those taken into account under paragraph (4)) shall be properly allocated or apportioned under regulations prescribed by the Secretary or his delegate.

SEC. 954. FOREIGN BASE COMPANY INCOME.

(a) Foreign Base Company Income.—For purposes of section 952(a)(2), the term "foreign base company income" means for any taxable year the sum of—

(1) the foreign personal holding company income for the taxable year (determined under subsection (c) and reduced as provided in subsection (b)(5)),

(2) the foreign base company sales income for the taxable year (determined under subsection (d) and reduced as provided in subsection (b)(5), and

(3) the foreign base company services income for the taxable year (determined under subsection (e) and reduced as provided in subsection (b)(5)).

(b) Exclusions and Special Rules.—

(1) Exclusion of certain dividends, interest, and gains from qualified investments in less developed countries.—For purposes of subsection (a), foreign base company income does not include—

(A) dividends and interest received during the taxable year from investments which at the time of receipt are qualified investments in less developed countries (as defined in section 955(b)), or

(B) if the gains from the sale or exchange during the taxable year of investments which at the time of sale or exchange are qualified investments in less developed countries exceed the losses from the sale or exchange during the taxable year of such qualified investments, the amount by which such gains exceed such losses.

The preceding sentence shall apply only to the extent that the sum of the dividends and interest described in subparagraph (A) and the amount described in subparagraph (B) does not exceed the increase for the taxable year in qualified investments in less developed countries of the controlled foreign corporation (as determined under subsection (f)).

(2) Exclusion of certain shipping income.—For purposes of subsection (a), foreign base company income does not include income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce, or the performance of services directly related to the use of any such aircraft or vessel.

(3) Special rule where foreign base company income is less than 30 percent or more than 70 percent of gross income.—For purposes of subsection (a)—

(A) If the foreign base company income (determined without regard to paragraphs (1) and (5)) is less than 30 percent of gross income, no part of the gross income of the taxable year shall be treated as foreign base company income.

(B) If the foreign base company income (determined without regard to paragraphs (1) and (5)) exceeds 70 percent of gross income, the entire gross income of the taxable year shall, subject to the provisions of paragraphs (1), (2), (4), and (5), be treated as foreign base company income.

(4) Exception for foreign corporations not availed of to reduce taxes.—For purposes of subsection (a), foreign base company income does not include any item of income received by a controlled foreign corporation

if it is established to the satisfaction of the Secretary or his delegate with respect to such item that the creation or organization of the controlled foreign corporation receiving such item under the laws of the foreign country in which it is incorporated does not have the effect of substantial reduction of income, war profits, or excess profits taxes or similar taxes.

(5) DEDUCTIONS TO BE TAKEN INTO ACCOUNT.—For purposes of subsection (a), the foreign personal holding company income, the foreign base company sales income, and the foreign base company services income shall be reduced, under regulations prescribed by the Secretary or his delegate, so as to take into account deductions (including taxes) properly allocable to such income.

(c) FOREIGN PERSONAL HOLDING COMPANY INCOME.—

(1) IN GENERAL.—For purposes of subsection (a)(1), the term "foreign personal holding company income" means the foreign personal holding company income (as defined in section 553), modified and adjusted as provided in paragraphs (2), (3), and (4).

(2) RENTS INCLUDED WITHOUT REGARD TO 50 PERCENT LIMITATION.—For purposes of paragraph (1), all rents shall be included in foreign personal holding company income without regard to whether or not such rents constitute 50 percent or more of gross income.

(3) CERTAIN INCOME DERIVED IN ACTIVE CONDUCT OF TRADE OR BUSINESS.—For purposes of paragraph (1), foreign personal holding company income does not include—

(A) rents and royalties which are derived in the active conduct of a trade or business and which are received from a person other than a related person (within the meaning of subsection (d)(3)), or

(B) dividends, interest, and gains from the sale or exchange of stock or securities derived in the conduct of a banking, financing, or similar business, or derived from the investments made by an insurance company of its unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business, and which are received from a person other than a related person (within the meaning of subsection (d)(3)).

(4) CERTAIN INCOME RECEIVED FROM RELATED PERSONS.—For purposes of paragraph (1), foreign personal holding company income does not include—

(A) dividends and interest received from a related person which (i) is created or organized under the laws of the same foreign country under the laws of which the controlled foreign corporation is created or organized, and (ii) has a substantial part of its assets used in its trade or business located in such same foreign country;

(B) interest received in the conduct of a banking, financing, or similar business from a related person engaged in the conduct of a banking, financing, or similar business if the businesses of the recipient and the payor are predominantly with persons other than related persons; and

(C) rents, royalties, and similar amounts received from a related person for the use of, or the privilege of using, property within the country under the laws of which the controlled foreign corporation is created or organized.

(d) FOREIGN BASE COMPANY SALES INCOME.—

(1) IN GENERAL.—For purposes of subsection (a)(2), the term "foreign base company sales income" means income (whether in the form of profits, commissions, fees, or otherwise) derived in connection with the purchase of personal property from a related person and its sale to any person, the sale of personal property to any person on behalf of a related person, the purchase of personal property from any person and its sale to a related person, or the purchase of personal property from any person on behalf of a related person where—

(A) the property which is purchased (or in the case of property sold on behalf of a related person, the property which is sold) is manufactured, produced, grown, or extracted outside the country under the laws of which the controlled foreign corporation is created or organized, and

(B) the property is sold for use, consumption, or disposition outside such foreign country, or, in the case of property purchased on behalf of a related person, is purchased for use, consumption, or disposition outside such foreign country.

(2) CERTAIN BRANCH INCOME.—For purposes of determining foreign base company sales income in situations in which the carrying on of activities by a controlled foreign corporation through a branch or similar establishment outside the country of incorporation of the controlled foreign corporation has substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation deriving such income, under regulations prescribed by the Secretary or his delegate the income attributable to the carrying on of such activities of such branch or similar establishment shall be treated as income derived by a wholly owned subsidiary of the controlled foreign corporation and shall constitute foreign base company sales income of the controlled foreign corporation.

(3) RELATED PERSON DEFINED.—For purposes of this section, a person is a related person with respect to a controlled foreign corporation, if—

(A) such person is an individual, partnership, trust, or estate which controls the controlled foreign corporation;

(B) such person is a corporation which controls, or is controlled by, the controlled foreign corporation; or

(C) such person is a corporation which is controlled by the same person or persons which control the controlled foreign corporation.

For purposes of the preceding sentence, control means the ownership, directly or indirectly, of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote. For purposes of this paragraph, the rules for determining ownership of stock prescribed by section 958 shall apply.

(e) FOREIGN BASE COMPANY SERVICES INCOME.—For purposes of subsection (a) (3), the term "foreign base company services income" means income (whether in the form of compensation, commissions, fees, or otherwise) derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which—

(1) are performed for or on behalf of any related person (within the meaning of subsection (d) (3), and

(2) are performed outside the country under the laws of which the controlled foreign corporation is created or organized.

The preceding sentence shall not apply to income derived in connection with the performance of services which are directly related to the sale or exchange by the controlled foreign corporation of property manufactured, produced, grown, or extracted by it and which are performed prior to the time of the sale or exchange, or of services directly related to an offer or effort to sell or exchange such property.

(f) INCREASE IN QUALIFIED INVESTMENTS IN LESS DEVELOPED COUNTRIES.—For purposes of subsection (b) (1), the increase for any taxable year in qualified investments in less developed countries of any controlled foreign corporation is the amount by which—

(1) the qualified investments in less developed countries (as defined in section 955(b)) of the controlled foreign corporation at the close of the taxable year, exceeds

(2) the qualified investments in less developed countries (as so defined) of the controlled foreign corporation at the close of the preceding taxable year.

SEC. 955. WITHDRAWAL OF PREVIOUSLY EXCLUDED SUBPART F INCOME FROM QUALIFIED INVESTMENT.

(a) GENERAL RULES.—

(1) AMOUNT WITHDRAWN.—For purposes of this subpart, the amount of previously excluded subpart F income of any controlled foreign corporation withdrawn from investment in less developed countries for any taxable year is an amount equal to the decrease in the amount of qualified investments in less developed countries of the controlled foreign corporation for such year, but only to the extent that the amount of such decrease does not exceed an amount equal to—

(A) the sum of the amounts excluded under section 954 (b) (1) from the foreign base company income of such corporation for all prior taxable years, reduced by

(B) the sum of the amounts of previously excluded subpart F income withdrawn from investment in less developed countries of such corporation determined under this subsection for all prior taxable years.

(2) DECREASE IN QUALIFIED INVESTMENTS.—For purposes of paragraph (1), the amount of the decrease in qualified investments in less developed countries of any controlled foreign corporation for any taxable year is the amount by which—

(A) the amount of qualified investments in less developed countries of the controlled foreign corporation at the close of the preceding taxable year, exceeds

(B) the amount of qualified investments in less developed countries of the controlled foreign corporation at the close of the taxable year,

to the extent the amount of such decrease does not exceed the sum of the earnings and profits for the taxable year and the earnings and profits accumulated for prior taxable years beginning after December 31, 1962. For purposes of this paragraph, if qualified investments in less developed countries are disposed of by the controlled foreign corporation during the taxable year, the amount of the decrease in qualified investments in less developed countries of such controlled foreign corporation for such year shall be reduced by an amount equal to the amount (if any) by which the losses on such dispositions during such year exceed the gains on such dispositions during such year.

(3) PRO RATA SHARE OF AMOUNT WITHDRAWN.—In the case of any United States shareholder, the pro rata share of the amount of previously excluded subpart F income of any controlled foreign corporation withdrawn from investment in less developed countries for any taxable year is his pro rata share of the amount determined under paragraph (1).

(b) QUALIFIED INVESTMENTS IN LESS DEVELOPED COUNTRIES.—

(1) IN GENERAL.—For purposes of this subpart, the term "qualified investments in less developed countries" means property which is—

(A) stock of a less developed country corporation held by the controlled foreign corporation, but only if the controlled foreign corporation owns 10 percent or more of the total combined voting power of all classes of stock of such less developed country corporation;

(B) an obligation of a less developed country corporation held by the controlled foreign corporation, which, at the time of its acquisition by the controlled foreign corporation, has a maturity of one year or more, but only if the controlled foreign corporation owns 10 percent or more of the total combined voting power of all classes of stock of such less developed country corporation; or

(C) an obligation of a less developed country.

(2) COUNTRY CEASES TO BE LESS DEVELOPED COUNTRY.—For purposes of this subpart, property which would be qualified investment in less developed countries, but for the fact that a foreign country has, after the acquisition of such property by the controlled foreign corporation, ceased to be a less developed country, shall be treated as a qualified investment in less developed countries.

(3) SPECIAL RULE.—For purposes of this subpart, a United States shareholder of a controlled foreign corporation may, under regulations prescribed by the Secretary or his delegate, make the determinations under subsection (a)(2) of this section and under subsection (f) of section 954 as of the close of the years following the years referred to in such subsections, or as of the close of such longer period of time as such regulations may permit, in lieu of on the last days of such years. Any election under this paragraph made with respect to any taxable year shall apply to such year and to all succeeding taxable years unless the Secretary or his delegate consents to the revocation of such election.

(4) EXCEPTION.—For purposes of this subpart, property shall not constitute qualified investments in less developed countries if such property is disposed of within 6 months after the date of its acquisition.

(5) AMOUNT ATTRIBUTABLE TO PROPERTY.—The amount taken into account under this subpart with respect to any property described in paragraph (1) or (2) shall be its adjusted basis, reduced by any liability to which such property is subject.

(c) LESS DEVELOPED COUNTRY CORPORATIONS.—

(1) IN GENERAL.—For purposes of this subpart, the term "less developed country corporation" means a foreign corporation which during the taxable year is engaged in the active conduct of one or more trades or businesses and—

(A) 80 percent or more of the gross income of which for the taxable year is derived from sources within less developed countries; and

(B) 80 percent or more in value of the assets of which on each day of the taxable year consists of—

(i) property used in such trades or businesses and located in less developed countries,

(ii) money, and deposits with persons carrying on the banking business,

(iii) stock, and obligations which, at the time of their acquisition, have a maturity of one year or more, of any other less developed country corporation,

(iv) an obligation of a less developed country,

(v) an investment which is required because of restrictions imposed by a less developed country, and

(vi) property described in section 956(b)(2).

For purposes of subparagraph (A), the determination as to whether income is derived from sources within less developed countries shall be made under regulations prescribed by the Secretary or his delegate.

(2) SHIPPING COMPANIES.—For purposes of this subpart, the term "less developed country corporation" also means a foreign corporation—

(A) 80 percent or more of the gross income of which for the taxable year consists of—

(i) gross income derived from, or in connection with, the using (or hiring or leasing for use) in foreign commerce of aircraft or vessels registered under the laws of a less developed country, or from, or in connection with, the performance of services directly related to use of such aircraft or vessels, or from the sale or exchange of such aircraft or vessels, and

(ii) dividends and interest received from foreign corporations which are less developed country corporations within the meaning of this paragraph and 10 percent or more of the total combined voting power of all classes of stock of which are owned by the foreign corporation, and gain from the sale or exchange of stock or obligations of foreign corporations which are such less developed country corporations, and

(B) 80 percent or more of the assets of which on each day of the taxable year consists of (i) assets used, or held for use, for or in connection with the production of income described in subparagraph (A), and (ii) property described in section 956(b)(2).

(3) LESS DEVELOPED COUNTRY DEFINED.—For purposes of this subpart, the term "less developed country" means (in respect of any foreign corporation) any foreign country (other than an area within the Sino-Soviet bloc) or any possession of the United States with respect to which, on the first day of the taxable year, there is in effect an Executive order by the President of the United States designating such country or possession as an economically less developed country for purposes of this subpart. For purposes of the preceding sentence, an overseas territory, department, province, or possession may be treated as a separate country. No designation shall be made under this paragraph with respect to—

Australia
Austria
Belgium
Canada
Denmark
France
Germany (Federal Republic)
Hong Kong
Italy
Japan
Lichtenstein
Luxembourg
Monaco
Netherlands
New Zealand
Norway
Union of South Africa
San Marino
Sweden
Switzerland
United Kingdom

After the President has designated any foreign country or any possession of the United States as an economically less developed country for purposes of this subpart, he shall not terminate such designation (either by issuing an Executive order for that purpose or by issuing an Executive order under the first sentence of this paragraph which has the effect of terminating such designation) unless, at least 30 days prior to such termination, he has notified the Senate and the House of Representatives of his intention to terminate such designation.

SEC. 956. INVESTMENT OF EARNINGS IN UNITED STATES PROPERTY.

(a) General Rules.—For purposes of this subpart—

(1) Amount of investment.—The amount of earnings of a controlled foreign corporation invested in United States property at the close of any taxable year is the aggregate amount of such property held, directly or indirectly, by the controlled foreign corporation at the close of the taxable year, to the extent such amount would have constituted a dividend (determined after the application of section 955(a)) if it had been distributed.

(2) Pro rata share of increase for year.—In the case of any United States shareholder, the pro rata share of the increase for any taxable year in the earnings of a controlled foreign corporation invested in United States property is the amount determined by subtracting his pro rata share of—

(A) the amount determined under paragraph (1) for the close of the preceding taxable year, reduced by amounts paid during such preceding taxable year to which section 959(c)(1) applies, from

(B) the amount determined under paragraph (1) for the close of the taxable year.

The determinations under subparagraphs (A) and (B) shall be made on the basis of stock owned (within the meaning of section 958(a)) by such United States shareholder on the last day during the taxable year on which the foreign corporation is a controlled foreign corporation.

(3) Amount attributable to property.—The amount taken into account under paragraph (1) or (2) with respect to any property shall be its adjusted basis, reduced by any liability to which the property is subject.

(b) United States Property Defined.—

(1) In general.—For purposes of subsection (a), the term "United States property" means any property acquired after December 31, 1962, which is—

(A) tangible property located in the United States;

(B) stock of a domestic corporation;

(C) an obligation of a United States person; or

(D) any right to the use in the United States of—

(i) a patent or copyright,

(ii) an invention, model, or design (whether or not patented),

(iii) a secret formula or process, or

(iv) any other similar property right,

which is acquired or developed by the controlled foreign corporation for use in the United States.

(2) Exceptions.—For purposes of subsection (a), the term "United States property" does not include—

(A) obligations of the United States, money, or deposits with persons carrying on the banking business;

(B) property located in the United States which is purchased in the United States for export to, or use in, foreign countries;

(C) any obligation of a United States person arising in connection with the sale or processing of property if the amount of such obligation outstanding at no time during the taxable year exceeds the amount which would be ordinary and necessary to carry on the trade or business of both the other party to the sale or processing transaction and the United States person had the sale or processing transaction been made between unrelated persons;

(D) any aircraft, railroad rolling stock, vessel, motor vehicle, or container used in the transportation of persons or property in foreign commerce and used predominantly outside the United States;

(E) an amount of assets of an insurance company equivalent to the unearned premiums or reserves ordinary and necessary for the proper

conduct of its insurance business attributable to contracts which are not contracts described in section 953(a)(1); and

(F) an amount of assets of the controlled foreign corporation equal to the earnings and profits accumulated after December 31, 1962, and excluded from subpart F income under section 952(b).

(c) Pledges and Guarantees.—For purposes of subsection (a), a controlled foreign corporation shall, under regulations prescribed by the Secretary or his delegate, be considered as holding an obligation of a United States person if such controlled foreign corporation is a pledgor or guarantor of such obligation.

SEC. 957. CONTROLLED FOREIGN CORPORATIONS; UNITED STATES PERSONS.

(a) General Rule.—For purposes of this subpart, the term "controlled foreign corporation" means any foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such foreign corporation.

(b) Special Rule for Insurance.—For purposes only of taking into account income described in section 953(a) (relating to income derived from insurance of United States risks), the term "controlled foreign corporation" includes not only a foreign corporation as defined by subsection (a) but also one of which more than 25 percent of the total combined voting power of all classes of stock is owned (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such corporation, if the gross amount of premiums or other consideration in respect of the reinsurance or the issuing of insurance or annuity contracts described in section 953(a)(1) exceeds 75 percent of the gross amount of all premiums or other consideration in respect of all risks.

(c) Corporations Organized in United States Possessions.—For purposes of this subpart, the term "controlled foreign corporation" does not include any corporation created or organized in the Commonwealth of Puerto Rico or a posession of the United States or under the laws of the Commonwealth of Puerto Rico or a possession of the United States if—

(1) 80 percent or more of the gross income of such corporation for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within the Commonwealth of Puerto Rico or a possession of the United States; and

(2) 50 percent or more of the gross income of such corporation for such period, or for such part thereof, was derived from the active conduct within the Commonwealth of Puerto Rico or a possession of the United States of any trades or businesses constituting the manufacture or processing of goods, wares, merchandise, or other tangible personal property; the processing of agricultural or horticultural products or commodities (including but not limited to livestock, poultry, or fur-bearing animals); the catching or taking of any kind of fish or the mining or extraction of natural resources, or any manufacturing or processing of any products or commodities obtained from such activities; or the ownership or operation of hotels.

For purposes of paragraphs (1) and (2), the determination as to whether income was derived from sources within the Commonwealth of Puerto Rico or a possession of the United States and was derived from the active conduct of a described trade or business within the Commonwealth of Puerto Rico or a possession of the United States shall be made under regulations prescribed by the Secretary or his delegate.

(d) United States Person.—For purposes of this subpart, the term "United States person" has the meaning assigned to it by section 7701(a)(30) except that—

(1) with respect to a corporation organized under the laws of the Commonwealth of Puerto Rico, such term does not include an individual who is a bona fide resident of Puerto Rico, if a dividend received by such individual during the taxable year from such corporation would, for purposes of section 933(1), be treated as income derived from sources within Puerto Rico,

(2) with respect to a corporation organized under the laws of the Virgin Islands, such term does not include an individual who is a bona fide resident

of the Virgin Islands and whose income tax obligation under this subtitle for the taxable year is satisfied pursuant to section 28(a) of the Revised Organic Act of the Virgin Islands, approved July 22, 1954 (48 U.S.C. 1642), by paying tax on income derived from all sources both within and outside the Virgin Islands into the treasury of the Virgin Islands, and

(3) with respect to a corporation organized under the laws of any other possession of the United States, such term does not include an individual who is a bona fide resident of any such other possession and whose income derived from sources within possessions of the United States is not, by reason of section 931(a), includible in gross income under this subtitle for the taxable year.

SEC. 958. RULES FOR DETERMINING STOCK OWNERSHIP.

(a) Direct and Indirect Ownership.—

(1) General rule.—For purposes of this subpart (other than sections 955(b)(1) (A) and (B), 955(c)(2)(A)(ii), and 960(a)(1)), stock owned means—

(A) stock owned directly, and

(B) stock owned with the application of paragraph (2).

(2) Stock ownership through foreign entities.—For purposes of subparagraph (B) of paragraph (1), stock owned, directly or indirectly, by or for a foreign corporation, foreign partnership, or foreign trust or foreign estate (within the meaning of section 7701(a)(31)) shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries. Stock considered to be owned by a person by reason of the application of the preceding sentence shall, for purposes of applying such sentence, be treated as actually owned by such person.

(3) Special rule for mutual insurance companies.—For purposes of applying paragraph (1) in the case of a foreign mutual insurance company, the term "stock" shall include any certificate entitling the holder to voting power in the corporation.

(b) Constructive Ownership.—For purposes of sections 951(b), 954(d)(3), and 957, section 318(a) (relating to constructive ownership of stock) shall apply to the extent that the effect is to treat any United States person as a United States shareholder within the meaning of section 951(b), to treat a person as a related person within the meaning of section 954(d)(3), or to treat a foreign corporation as a controlled foreign corporation under section 957, except that—

(1) In applying paragraph (1)(A) of section 318(a), stock owned by a nonresident alien individual (other than a foreign trust or foreign estate) shall not be considered as owned by a citizen or by a resident alien individual.

(2) In applying the first sentence of subparagraphs (A) and (B), and in applying clause (i) of subparagraph (C), of section 318(a)(2), if a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50 percent of the total combined voting power of all classes of stock entitled to vote of a corporation, it shall be considered as owning all the stock entitled to vote.

(3) Stock owned by a partnership, estate, trust, or corporation, by reason of the application of the second sentence of subparagraphs (A) and (B), and the application of clause (ii) of subparagraph (C), of section 318(a)(2), shall not be considered as owned by such partnership, estate, trust, or corporation, for purposes of applying the first sentence of subparagraphs (A) and (B), and in applying clause (i) of subparagraph (C), of section 318(a)(2).

(4) In applying clause (i) of subparagraph (C) of section 318(a)(2), the phrase "10 percent" shall be substituted for the phrase "50 percent" used in subparagraph (C).

(5) The second sentence of subparagraphs (A) and (B), and clause (ii) of subparagraph (C), of section 318(a)(2) shall not be applied so as to consider a United States person as owning stock which is owned by a person who is not a United States person.

SEC. 959. EXCLUSION FROM GROSS INCOME OF PREVIOUSLY TAXED EARNINGS AND PROFITS.

(a) Exclusion From Gross Income of United States Persons.—For purposes of this chapter, the earnings and profits for a taxable year of a foreign corpora-

tion attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a) shall not, when—

(1) such amounts are distributed to, or

(2) such amounts would, but for this subsection, be included under section 951(a)(1)(B) in the gross income of,

such shareholder (or any other United States person who acquires from any person any portion of the interest of such United States shareholder in such foreign corporation, but only to the extent of such portion, and subject to such proof of the identity of such interest as the Secretary or his delegate may by regulations prescribe) directly, or indirectly through a chain of ownership described under section 958(a), be again included in the gross income of such United States shareholder (or of such other United States person).

(b) Exclusion From Gross Income of Certain Foreign Subsidiaries.—For purposes of section 951(a), the earnings and profits for a taxable year of a controlled foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a), shall not, when distributed through a chain of ownership described under section 958(a), be also included in the gross income of another controlled foreign corporation in such chain for purposes of the application of section 951(a) to such other controlled foreign corporation with respect to such United States shareholder (or to any other United States shareholder who acquires from any person any portion of the interest of such United States shareholder in the controlled foreign corporation, but only to the extent of such portion, and subject to such proof of identity of such interest as the Secretary or his delegate may prescribe by regulations).

(c) Allocation of Distributions.—For purposes of subsections (a) and (b), section 316(a) shall be applied by applying paragraph (2) thereof, and then paragraph (1) thereof—

(1) first to earnings and profits attributable to amounts included in gross income under section 951(a)(1)(B) (or which would have been included except for subsection (a)(2) of this section),

(2) then to earnings and profits attributable to amounts included in gross income under section 951(a)(1)(A) (but reduced by amounts not included under section 951(a)(1)(B) because of the exclusion in subsection (a)(2) of this section), and

(3) then to other earnings and profits.

(d) Distributions Excluded From Gross Income Not To Be Treated as Dividends.—Except as provided in section 960(a)(3), any distribution excluded from gross income under subsection (a) shall be treated, for purposes of this chapter, as a distribution which is not a dividend.

SEC. 960. SPECIAL RULES FOR FOREIGN TAX CREDIT.

(a) Taxes Paid by a Foreign Corporation.—

(1) General rule.—For purposes of subpart A of this part, if there is included, under section 951(a), in the gross income of a domestic corporation any amount attributable to earnings and profits—

(A) of a foreign corporation at least 10 percent of the voting stock of which is owned by such domestic corporation, or

(B) of a foreign corporation at least 50 percent of the voting stock of which is owned by a foreign corporation at least 10 percent of the voting stock of which is in turn owned by such domestic corporation,

then, under regulations prescribed by the Secretary or his delegate, such domestic corporation shall be deemed to have paid the same proportion of the total income, war profits, and excess profits taxes paid (or deemed paid) by such foreign corporation to a foreign country or possession of the United States for the taxable year on or with respect to the earnings and profits of such foreign corporation which the amount of earnings and profits of such foreign corporation so included in gross income of the domestic corporation bears to—

(C) if the foreign corporation at least 10 percent of the voting stock of which is owned by such domestic corporation referred to in subparagraph (A) or (B) is not a less developed country corporation (as defined in section 902(d)) for such taxable year, the entire amount of the earnings and profits of such foreign corporation for such taxable year, or

(D) if the foreign corporation at least 10 percent of the voting stock of which is owned by such domestic corporation referred to in subparagraph (A) or (B) is a less developed country corporation (as defined in section 902(d)) for such taxable year, the sum of the entire amount of the earnings and profits of such foreign corporation for such taxable year and the total income, war profits, and excess profits taxes paid by such foreign corporation to foreign countries or possessions of the United States for such taxable year.

(2) TAXES PREVIOUSLY DEEMED PAID BY DOMESTIC CORPORATION.—If a domestic corporation receives a distribution from a foreign corporation, any portion of which is excluded from gross income under section 959, the income, war profits, and excess profits taxes paid or deemed paid by such foreign corporation to any foreign country or to any possession of the United States in connection with the earnings and profits of such foreign corporation from which such distribution is made shall not be taken into account for purposes of section 902, to the extent such taxes were deemed paid by a domestic corporation under paragraph (1) for any prior taxable year.

(3) TAXES PAID BY FOREIGN CORPORATION AND NOT PREVIOUSLY DEEMED PAID BY DOMESTIC CORPORATION.—Any portion of a distribution from a foreign corporation received by a domestic corporation which is excluded from gross income under section 959(a) shall be treated by the domestic corporation as a dividend, solely for purposes of taking into account under section 902 any income, war profits, or excess profits taxes paid to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of such foreign corporation from which such distribution is made, which were not deemed paid by the domestic corporation under paragraph (1) for any prior taxable year.

(b) SPECIAL RULES FOR FOREIGN TAX CREDIT IN YEAR OF RECEIPT OF PREVIOUSLY TAXED EARNINGS AND PROFITS.—

(1) INCREASE IN SECTION 904 LIMITATION.—In the case of any taxpayer who—

(A) either (i) chose to have the benefits of subpart A of this part for a taxable year in which he was required under section 951(a) to include in his gross income an amount in respect of a controlled foreign corporation, or (ii) did not pay or accrue for such taxable year any income, war profits, or excess profits taxes to any foreign country or to any possession of the United States, and

(B) chooses to have the benefits of subpart A of this part for the taxable year in which he receives a distribution or amount which is excluded from gross income under section 959(a) and which is attributable to earnings and profits of the controlled foreign corporation which was included in his gross income for the taxable year referred to in subparagraph (A), and

(C) for the taxable year in which such distribution or amount is received, pays, or is deemed to have paid, or accrues income, war profits, or excess profits taxes to a foreign country or to any possession of the United States with respect to such distribution or amount,

the applicable limitation under section 904 for the taxable year in which such distribution or amount is received shall be increased as provided in paragraph (2), but such increase shall not exceed the amount of such taxes paid, or deemed paid, or accrued with respect to such distribution or amount.

(2) AMOUNT OF INCREASE.—The amount of increase of the applicable limitation under section 904(a) for the taxable year in which the distribution or amount referred to in paragraph (1)(B) is received shall be an amount equal to—

(A) the amount by which the applicable limitation under section 904(a) for the taxable year referred to in paragraph (1)(A) was increased by reason of the inclusion in gross income under section 951(a) of the amount in respect of the controlled foreign corporation, reduced by

(B) the amount of any income, war profits, and excess profits taxes paid, or deemed paid, or accrued to any foreign country or possession of the United States which were allowable as a credit under section 901 for the taxable year referred to in paragraph (1)(A) and which would not have been allowable but for the inclusion in gross income of the amount described in subparagraph (A).

(3) Cases in which taxes not to be allowed as deduction.—In the case of any taxpayer who—

(A) chose to have the benefits of subpart A of this part for a taxable year in which he was required under section 951(a) to include in his gross income an amount in respect of a controlled foreign corporation, and

(B) does not choose to have the benefits of subpart A of this part for the taxable year in which he receives a distribution or amount which is excluded from gross income under section 959(a) and which is attributable to earnings and profits of the controlled foreign corporation which was included in his gross income for the taxable year referred to in subparagraph (A),

no deduction shall be allowed under section 164 for the taxable year in which such distribution or amount is received for any income, war profits, or excess profits taxes paid or accrued to any foreign country or to any possession of the United States on or with respect to such distribution or amount.

(4) Insufficient taxable income.—If an increase in the limitation under this subsection exceeds the tax imposed by this chapter for such year, the amount of such excess shall be deemed an overpayment of tax for such year.

SEC. 961. ADJUSTMENTS TO BASIS OF STOCK IN CONTROLLED FOREIGN CORPORATIONS AND OF OTHER PROPERTY.

(a) Increase in Basis.—Under regulations prescribed by the Secretary or his delegate, the basis of a United States shareholder's stock in a controlled foreign corporation, and the basis of property of a United States shareholder by reason of which he is considered under section 958(a)(2) as owning stock of a controlled foreign corporation, shall be increased by the amount required to be included in his gross income under section 951(a) with respect to such stock or with respect to such property, as the case may be, but only to the extent to which such amount was included in the gross income of such United States shareholder. In the case of a United States shareholder who has made an election under section 962 for the taxable year, the increase in basis provided by this subsection shall not exceed an amount equal to the amount of tax paid under this chapter with respect to the amounts required to be included in his gross income under section 951(a).

(b) Reduction in Basis.—

(1) In general.—Under regulations prescribed by the Secretary or his delegate, the adjusted basis of stock or other property with respect to which a United States shareholder or a United States person receives an amount which is excluded from gross income under section 959(a) shall be reduced by the amount so excluded. In the case of a United States shareholder who has made an election under section 962 for any prior taxable year, the reduction in basis provided by this paragraph shall not exceed an amount equal to the amount received which is excluded from gross income under section 959(a) after the application of section 962(d).

(2) Amount in excess of basis.—To the extent that an amount excluded from gross income under section 959(a) exceeds the adjusted basis of the stock or other property with respect to which it is received, the amount shall be treated as gain from the sale or exchange of property.

SEC. 962. ELECTION BY INDIVIDUALS TO BE SUBJECT TO TAX AT CORPORATE RATES.

(a) General Rule.—Under regulations prescribed by the Secretary or his delegate, in the case of a United States shareholder who is an individual and who elects to have the provisions of this section apply for the taxable year—

(1) the tax imposed under this chapter on amounts which are included in his gross income under section 951(a) shall (in lieu of the tax determined under section 1) be an amount equal to the tax which would be imposed under section 11 if such amounts were received by a domestic corporation, and

(2) for purposes of applying the provisions of section 960 (relating to foreign tax credit) such amounts shall be treated as if they were received by a domestic corporation.

(b) Election.—An election to have the provisions of this section apply for any taxable year shall be made by a United States shareholder at such time and in such manner as the Secretary or his delegate shall prescribe by regula-

tions. An election made for any taxable year may not be revoked except with the consent of the Secretary or his delegate.

(c) SURTAX EXEMPTION.—For purposes of applying subsection (a)(1), the surtax exemption provided by section 11(c) shall not exceed, in the case of any United States shareholder, an amount which bears the same ratio to $25,000 as the amounts included in his gross income under section 951(a) for the taxable year bears to his pro rata share of the earnings and profits for the taxable year of all controlled foreign corporations with respect to which such United States shareholder includes any amount in gross income under section 951(a).

(d) SPECIAL RULE FOR ACTUAL DISTRIBUTIONS.—The earnings and profits of a foreign corporation attributable to amounts which were included in the gross income of a United States shareholder under section 951(a) and with respect to which an election under this section applied shall, when such earnings and profits are distributed, notwithstanding the provisions of section 959(a)(1), be included in gross income to the extent that such earnings and profits so distributed exceed the amount of tax paid under this chapter on the amounts to which such election applied.

SEC. 963. RECEIPT OF MINIMUM DISTRIBUTIONS BY DOMESTIC CORPORATIONS.

(a) GENERAL RULE.—In the case of a United States shareholder which is a domestic corporation and which consents to all the regulations prescribed by the Secretary or his delegate under this section prior to the last day prescribed by law for filing its return of the tax imposed by this chapter for the taxable year, no amount shall be included in gross income under section 951(a)(1)(A)(i) for the taxable year with respect to the subpart F income of a controlled foreign corporation, if—

(1) in the case of a controlled foreign corporation described in subsection (c)(1), the United States shareholder receives a minimum distribution of the earnings and profits for the taxable year of such controlled foreign corporation;

(2) in the case of controlled foreign corporations described in subsection (c)(2), the United States shareholder receives a minimum distribution with respect to the consolidated earnings and profits for the taxable year of all such controlled foreign corporations; or

(3) in the case of controlled foreign corporations described in subsection (c)(3), the United States shareholder receives a minimum distribution of the consolidated earnings and profits for the taxable year of all such controlled foreign corporations.

(b) MINIMUM DISTRIBUTIONS.—For purposes of this section, a minimum distribution with respect to the earnings and profits for the taxable year of any controlled foreign corporation or corporations shall, in the case of any United States shareholder, be its pro rata share of an amount determined in accordance with the following table:

If the effective foreign tax rate is (percentage)—	The required minimum distribution of earnings and profits is (percentage)—
Under 10	90
10 or over but less than 20	86
20 or over but less than 28	82
28 or over but less than 34	75
34 or over but less than 39	68
39 or over but less than 42	55
42 or over but less than 44	40
44 or over but less than 46	27
46 or over but less than 47	14
47 or over	0

(c) AMOUNTS TO WHICH SECTION APPLIES.—

(1) FOREIGN SUBSIDIARIES.—Subsection (a)(1) shall apply to amounts which (but for the provisions of this section) would be included in the gross income of the United States shareholder under section 951(a)(1)(A)(i) by reason of its ownership, within the meaning of section 958(a)(1)(A), of stock of a controlled foreign corporation.

(2) CHAIN OF CONTROLLED FOREIGN CORPORATIONS.—Subsection (a)(2) shall apply to amounts which (but for the provisions of this section) would be included in the gross income of the United States shareholder under section 951(a)(1)(A)(i)—

(A) by reason of its ownership, within the meaning of section 958(a)(1)(A), of stock of a controlled foreign corporation, and

(B) to the extent that the United States shareholder so elects, by reason of its ownership, within the meaning of section 958(a)(2), of stock of any other controlled foreign corporation (on account of its ownership of the stock described in subparagraph (A) or of stock described in this subparagraph), but only if there is taken into account the earnings and profits of each foreign corporation, whether or not a controlled foreign corporation, by reason of which the United States shareholder owns, within the meaning of section 958(a)(2), stock of such controlled foreign corporation.

(3) ALL CONTROLLED FOREIGN CORPORATIONS.—Except as provided in paragraph (4), subsection (a)(3) shall apply to amounts which (but for the provisions of this section) would be included in the gross income of the United States shareholder under section 951(a)(1)(A)(i)—

(A) by reason of its ownership, within the meaning of section 958(a)(1)(A), of stock of all controlled foreign corporations in which it owns stock within the meaning of such section, and

(B) by reason of its ownership, within the meaning of section 958(a)(2), of stock of all controlled foreign corporations in which it owns stock within the meaning of such section, but only if there is taken into account the earnings and profits of each foreign corporation, whether or not a controlled foreign corporation, by reason of which the United States shareholder owns, within the meaning of section 958(a), stock of any such controlled foreign corporations.

(4) EXCEPTIONS AND SPECIAL RULES.—

(A) LESS DEVELOPED COUNTRY CORPORATIONS.—If the United States shareholder so elects, subsection (a)(3) and paragraph (3) of this subsection shall not apply to amounts which would be included in the gross income of such shareholder under section 951(a)(1)(A)(i) by reason of its ownership, within the meaning of section 958(a), of stock of controlled foreign corporations which are less developed country corporations (as defined in section 955(c)). This subparagraph shall not apply with respect to a less developed country corporation if, by reason of the ownership of the stock of such corporation, the United States shareholder owns, within the meaning of section 958(a)(2), stock of any other controlled foreign corporation which is not a less developed country corporation. Except as provided in the preceding sentence, an election under this subparagraph may be made only with respect to all controlled foreign corporations which are less developed country corporations and with respect to which the domestic corporation making the election is a United States shareholder.

(B) FOREIGN BRANCHES.—In applying subsection (a)(3) and paragraph (3) of this subsection, if a United States shareholder so elects, all branches maintained by such shareholder in foreign countries, the Commonwealth of Puerto Rico, or possessions of the United States shall, under regulations prescribed by the Secretary or his delegate, be treated as wholly owned subsidiary corporations of such shareholder organized under the laws of such foreign countries, the Commonwealth of Puerto Rico, or possessions of the United States, as the case may be. Each branch so treated shall, for purposes of this section, be considered to have distributed to the United States shareholder all of its earnings and profits for the taxable year. This subparagraph shall not apply to a branch maintained by a United States shareholder in the Commonwealth of Puerto Rico or a possession of the United States unless—

(i) such branch would be a controlled foreign corporation (as defined in section 957) if it were incorporated under the laws of the Commonwealth of Puerto Rico or the possession of the United States, as the case may be, and

(ii) the gross income of the United States shareholder for the taxable year includes income derived from sources within the Commonwealth of Puerto Rico and possessions of the United States.

(C) BLOCKED FOREIGN INCOME.—If a United States shareholder so elects, the provisions of subsection (a)(3) and of paragraph (3) of this subsection shall not apply with respect to any foreign corporation, if it is established to the satisfaction of the Secretary or his delegate that the earnings and profits of such foreign corporation could not have

been distributed to United States shareholders who own (within the meaning of section 958(a)) stock of such foreign corporation because of currency or other restrictions or limitations imposed under the laws of any foreign country.

(d) Effective Foreign Tax Rate.—For purposes of this section, the term "effective foreign tax rate" means—

(1) with respect to a single controlled foreign corporation, the percentage which—

(A) the income, war profits, or excess profits taxes paid or accrued to foreign countries or possessions of the United States by the controlled foreign corporation for the taxable year on or with respect to its earnings and profits for the taxable year, is of

(B) the sum of (i) the earnings and profits of the controlled foreign corporation described in subparagraph (A) and (ii) and the taxes described in subparagraph (A); and

(2) with respect to two or more foreign corporations, the percentage which—

(A) the total income, war profits, or excess profits taxes paid or accrued to foreign countries or possessions of the United States by such foreign corporations for the taxable year on or with respect to the consolidated earnings and profits of such foreign corporations for the taxable year, is of

(B) the sum of (i) the consolidated earnings and profits of such foreign corporations described in subparagraph (A) and (ii) the taxes described in subparagraph (A).

For purposes of the preceding sentence, in the case of any United States shareholder, the computation of the effective foreign tax rate applicable with respect to any controlled foreign corporation or corporations shall be made without regard to distributions made by such controlled foreign corporation or corporations to such United States shareholder.

(e) Special Rules.—

(1) Year from which distributions are made.—For purposes of this section, the second sentence of section 902(c)(1) shall apply in determining from the earnings and profits of what year distributions are made by any foreign corporation, except that the Secretary or his delegate may by regulations provide a period in excess of 60 days in lieu of the 60-day period prescribed in such section.

(2) Insufficient distributions.—If—

(A) a United States shareholder, in making its return of the tax imposed by this chapter for any taxable year, applies the provisions of this section with respect to any controlled foreign corporation,

(B) it is subsequently determined that this section did not apply with respect to such controlled foreign corporation for such taxable year due to the failure of the United States shareholder to receive a minimum distribution with respect to such controlled foreign corporation, and

(C) such failure is due to reasonable cause,

then a subsequent distribution made with respect to such controlled foreign corporation may, if made at a time and in a manner prescribed by the Secretary or his delegate by regulations, be treated, for purposes of this chapter, as having been made for, and received in, the taxable year of the United States shareholder for which such shareholder applied the provisions of this section.

(3) Affiliated groups of corporations.—An affiliated group of corporations which makes a consolidated return under section 1501 for the taxable year, may, if it so elects, be treated as a single United States shareholder for purposes of applying this section for the taxable year.

(f) Regulations.—The Secretary or his delegate shall prescribe such regulations as he may deem necessary to carry out the provisions of this section, including regulations for the determination of the amount of foreign tax credit in the case of distributions with respect to the earnings and profits of two or more foreign corporations.

SEC. 964. MISCELLANEOUS PROVISIONS.

(a) Earnings and Profits.—For purposes of this subpart, the earnings and profits of any foreign corporation, and the deficit in earnings and profits of any

foreign corporation, for any taxable year shall be determined according to rules substantially similar to those applicable to domestic corporations, under regulations prescribed by the Secretary or his delegate.

(b) Blocked Foreign Income.—Under regulations prescribed by the Secretary or his delegate, no part of the earnings and profits of a controlled foreign corporation for any taxable year shall be included in earnings and profits for purposes of sections 952, 955, and 956, if it is established to the satisfaction of the Secretary or his delegate that such part could not have been distributed by the controlled foreign corporation to United States shareholders who own (within the meaning of section 958(a)) stock of such controlled foreign corporation because of currency or other restrictions or limitations imposed under the laws of any foreign country.

(c) Records and Accounts of United States Shareholders.—

(1) Records and accounts to be maintained.—The Secretary or his delegate may by regulations require each person who is, or has been, a United States shareholder of a controlled foreign corporation to maintain such records and accounts as may be prescribed by such regulations as necessary to carry out the provisions of this subpart and subpart G.

(2) Two or more persons required to maintain or furnish the same records and accounts with respect to the same foreign corporation.—Where, but for this paragraph, two or more United States persons would be required to maintain or furnish the same records and accounts as may by regulations be required under paragraph (1) with respect to the same controlled foreign corporation for the same period, the Secretary or his delegate may by regulations provide that the maintenance or furnishing of such records and accounts by only one such person shall satisfy the requirements of paragraph (1) for such other persons.

Subpart G—Export Trade Corporations

SEC. 970. REDUCTION OF SUBPART F INCOME OF EXPORT TRADE CORPORATIONS.

(a) Export Trade Income Constituting Foreign Base Company Income.—

(1) In general.—In the case of a controlled foreign corporation (as defined in section 957) which for the taxable year is an export trade corporation, the subpart F income (determined without regard to this subpart) of such corporation for such year shall be reduced by an amount equal to so much of the export trade income (as defined in section 971(b)) of such corporation for such year as constitutes foreign base company income (as defined in section 954), but only to the extent that such amount does not exceed whichever of the following amounts is the lesser:

(A) an amount equal to 1½ times so much of the export promotion expenses (as defined in section 971(d)) of such corporation for such year as is properly allocable to the export trade income which constitutes foreign base company income of such corporation for such year, or

(B) an amount equal to 10 percent of so much of the gross receipts for such year (or, in the case of gross receipts arising from commissions, fees, or other compensation for its services, so much of the gross amount upon the basis of which such commissions, fees, or other compensation is computed) accruing to such export trade corporation from the sale, installation, operation, maintenance, or use of property in respect of which such corporation derives export trade income as is property allocable to the export trade income which constitutes foreign base company income of such corporation for such year.

The allocations with respect to export trade income which constitutes foreign base company income under subparagraphs (A) and (B) shall be made under regulations prescribed by the Secretary or his delegate.

(2) Overall limitation.—The reduction under paragraph (1) for any taxable year shall not exceed an amount which bears the same ratio to the increase in the investments in export trade assets (as defined in section 971(c)) of such corporation for such year as the export trade income which

constitutes foreign base company income of such corporation for such year bears to the entire export trade income of such corporation for such year.

(b) Inclusion of Certain Previously Excluded Amounts.—Each United States shareholder of a controlled foreign corporation which for any prior taxable year was an export trade corporation shall include in his gross income under section 951(a)(1)(A)(ii), as an amount to which section 955 (relating to withdrawal of previously excluded subpart F income from qualified investment) applies, his pro rata share of the amount of decrease in the investments in export trade assets of such corporation for such year, but only to the extent that his pro rata share of such amount does not exceed an amount equal to—

(1) his pro rata share of the sum of (A) the amounts by which the subpart F income of such corporation was reduced for all prior taxable years under subsection (a), and (B) the amounts not included in subpart F income (determined without regard to this subpart) for all prior taxable years by reason of the application of section 972, reduced by

(2) the sum of the amounts which were included in his gross income under section 951(a)(1)(A)(ii) under the provisions of this subsection for all prior taxable years.

(c) Investments in Export Trade Assets.—

(1) Amount of investments.—For purposes of this section, the amount taken into account with respect to any export trade asset shall be its adjusted basis, reduced by any liability to which the asset is subject.

(2) Increase in investments in export trade assets.—For purposes of subsection (a), the amount of increase in investments in export trade assets of any controlled foreign corporation for any taxable year is the amount by which—

(A) the amount of such investments at the close of the taxable year, exceeds

(B) the amount of such investments at the close of the preceding taxable year.

(3) Decrease in investments in export trade assets.—For purposes of subsection (b), the amount of decrease in investments in export trade assets of any controlled foreign corporation for any taxable year is the amount by which—

(A) the amount of such investments at the close of the preceding taxable year (reduced by an amount equal to the amount of net loss sustained during the taxable year with respect to export trade assets), exceeds

(B) the amount of such investments at the close of the taxable year.

(4) Special rule.—A United States shareholder of an export trade corporation may, under regulations prescribed by the Secretary or his delegate, make the determinations under paragraphs (2) and (3) as of the close of the 75th day after the close of the years referred to in such paragraphs in lieu of on the last day of such years. A United States shareholder of an export trade corporation may, under regulations prescribed by the Secretary or his delegate, make the determinations under paragraphs (2) and (3) with respect to export trade assets described in section 971(c)(3) as of the close of the years following the years referred to in such paragraphs, or as of the close of such longer period of time as such regulations may permit, in lieu of on the last day of such years and in lieu of on the day prescribed in the preceding sentence. Any election under this paragraph made with respect to any taxable year shall apply to such year and to all succeeding taxable years unless the Secretary or his delegate consents to the revocation of such election.

SEC. 971. DEFINITIONS.

(a) Export Trade Corporations.—For purposes of this subpart, the term "export trade corporation" means—

(1) In general.—A controlled foreign corporation (as defined in section 957) which satisfies the following conditions:

(A) 90 percent or more of the gross income of such corporation for the 3-year period immediately preceding the close of the taxable year (or such part of such period subsequent to the effective date of this subpart during which the corporation was in existence) was derived from sources without the United States, and

(B) 75 percent or more of the gross income of such corporation for such period constituted gross income in respect of which such corporation derived export trade income.

(2) Special rule.—If 50 percent or more of the gross income of a controlled foreign corporation in the period specified in subsection (a) (1) (A) is gross income in respect of which such corporation derived export trade income in respect of agricultural products grown in the United States, it may qualify as an export trade corporation although it does not meet the requirements of subsection (a) (1) (B).

(b) Export Trade Income.— For the purposes of this subpart, the term "export trade income" means net income from—

(1) the sale to an unrelated person for use, consumption, or disposition outside the United States of export property (as defined in subsection (e)), or from commissions, fees, compensation, or other income from the performance of commercial, industrial, financial, technical, scientific, managerial, engineering, architectural, skilled, or other services in respect of such sales or in respect of the installation or maintenance of such export property;

(2) commissions, fees, compensation, or other income from commercial, industrial, financial, technical, scientific, managerial, engineering, architectural, skilled, or other services performed in connection with the use by an unrelated person outside the United States of patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property acquired or developed and owned by the manufacturer, producer, grower, or extractor of export property in respect of which the export trade corporation earns export trade income under paragaph (1);

(3) commissions, fees, rentals, or other compensation or income attributable to the use of export property by an unrelated person or attributable to the use of export property in the rendition of technical, scientific, or engineering services to an unrelated person; and

(4) interest from export trade assets described in subsection (c) (4).

For purposes of paragraph (3), if a controlled foreign corporation receives income from an unrelated person attributable to the use of export property in the rendition of services to such unrelated person together with income attributable to the rendition of other services to such unrelated person, including personal services, the amount of such aggregate income which shall be considered to be attributable to the use of the export property shall (if such amount cannot be established by reference to transactions between unrelated persons) be that part of such aggregate income which the cost of the export property consumed in the rendition of such services (including a reasonable allowance for depreciation) bears to the total costs and expenses attributable to such aggregate income.

(c) Export Trade Assets.—For purposes of this subpart, the term "export trade assets" means—

(1) working capital reasonably necessary for the production of export trade income,

(2) inventory of export property held for use, consumption, or disposition outside the United States,

(3) facilities located outside the United States for the storage, handling, transportation, packaging, or servicing of export property, and

(4) evidences of indebtedness executed by persons, other than related persons, in connection with payment for purchases of export property for use, consumption, or disposition, outside the United States, or in connection with the payment for services described in subsections (b) (2) and (3)

(d) Export Promotion Expenses.—For purposes of this subpart, the term "export promotion expenses" means the following expenses paid or incurred in the receipt or production of export trade income—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered for such purpose,

(2) rentals or other payments for the use of property actually used for such purpose,

(3) a reasonable allowance for the exhaustion, wear and tear, or obsolescence of property actually used for such purpose, and

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(4) any other ordinary and necessary expenses of the corporation to the extent reasonably allocable to the receipt or production of export trade income.

No expense incurred within the United States shall be treated as an export promotion expense within the meaning of the preceding sentence, unless at least 90 percent of each category of expenses described in such sentence is incurred outside the United States.

(e) EXPORT PROPERTY.—For purposes of this subpart, the term "export property" means any property or any interest in property manufactured, produced, grown, or extracted in the United States.

(f) UNRELATED PERSON.—For purposes of this subpart, the term "unrelated person" means a person other than a related person as defined in section 954(d)(3).

SEC. 972. CONSOLIDATION OF GROUP OF EXPORT TRADE CORPORATIONS.

For purposes of this subpart and subpart F of this part, a United States shareholder of a controlled foreign corporation which is an export trade corporation may, under regulations prescribed by the Secretary or his delegate, treat as a single control foreign corporation—

(1) such controlled foreign corporation,

(2) all controlled foreign corporations which are export trade corporations and 80 percent or more of the total combined voting power of all classes of stock entitled to vote of which is owned by such controlled foreign corporation; and

(3) all controlled foreign corporations which are export trade corporations and 80 percent or more of the total combined voting power of all classes of stock entitled to vote of which is owned by controlled foreign corporations described in paragraph (2).

(b) TECHNICAL AND CLERICAL AMENDMENTS.—

(1) Section 901 (relating to foreign tax credit) is amended by striking out "section 902" and inserting in lieu thereof "sections 902 and 960".

(2) Section 904(g) (as redesignated by section 10(a) of this Act is amended to read as follows:

(g) CROSS REFERENCES.—

(1) For increase of applicable limitation under subsection (a) for taxes paid with respect to amounts received which were included in the gross income of the taxpayer for a prior taxable year as a United States shareholder with respect to a controlled foreign corporation, see section 960(b).

(2) For special rule relating to the application of the credit provided by section 901 in the case of affiliated groups which included Western Hemisphere trade corporations for years in which the limitation provided by subsection (a)(2) applies, see section 1503(d).

(3) The table of subparts for part III of subchapter N of chapter 1 is amended by adding at the end thereof the following:

Subpart F. Controlled foreign corporations.
Subpart G. Export trade corporations.

(4) Section 1016(a) (relating to adjustments to basis) is amended by adding after paragraph (19) (as added by section 2(f) of this Act) the following new paragraph:

(20) to the extent provided in section 961 in the case of stock in controlled foreign corporations (or foreign corporations which were controlled foreign corporations) and of property by reason of which a person is considered as owning such stock.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to taxable years of foreign corporations beginning after December 31, 1962, and to taxable years of United States share-

holders within which or with which such taxable years of such foreign corporations end.

SEC. 13. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE PROPERTY.

(a) IN GENERAL.—

(1) Part IV of subchapter P of chapter 1 (relating to special rules for determining capital gains and losses) is amended by adding at the end thereof the following new section:

SEC. 1245. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE PROPERTY.

(a) GENERAL RULE.—

(1) ORDINARY INCOME.—Except as otherwise provided in this section, if section 1245 property is disposed of during a taxable year beginning after December 31, 1962, the amount by which the lower of—

(A) the recomputed basis of the property, or

(B)(i) in the case of a sale, exchange, or involuntary conversion, the amount realized, or

(ii) in the case of any other disposition, the fair market value of such property,

exceeds the adjusted basis of such property shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231. Such gain shall be recognized notwithstanding any other provision of this subtitle.

(2) RECOMPUTED BASIS.—For purposes of this section, the term "recomputed basis" means, with respect to any property, its adjusted basis recomputed by adding thereto all adjustments, attributable to periods after December 31, 1961, reflected in such adjusted basis on account of deductions (whether in respect of the same or other property) allowed or allowable to the taxpayer or to any other person for depreciation, or for amortization under section 168. For purposes of the preceding sentence, if the taxpayer can establish by adequate records or other sufficient evidence that the amount allowed for depreciation, or for amortization under section 168, for any period was less than the amount allowable, the amount added for such period shall be the amount allowed.

(3) SECTION 1245 PROPERTY.—For purposes of this section, the term "section 1245 property" means any property (other than livestock) which is or has been property of a character subject to the allowance for depreciation provided in section 167 and is either—

(A) personal property, or

(B) other property (not including a building or its structural components) but only if such other property is tangible and has an adjusted basis in which there are reflected adjustments described in paragraph (2) for a period in which such property (or other property)—

(i) was used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or

(ii) constituted research or storage facilities used in connection with any of the activities referred to in clause (i).

(b) EXCEPTIONS AND LIMITATIONS.—

(1) GIFTS.—Subsection (a) shall not apply to a disposition by gift.

(2) TRANSFERS AT DEATH.—Except as provided in section 691 (relating to income in respect of a decedent), subsection (a) shall not apply to a transfer at death.

(3) CERTAIN TAX-FREE TRANSACTIONS.—If the basis of property in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332, 351, 361, 371(a), 374(a), 721, or 731, then the amount of gain taken into account by the transferor under subsection (a)(1) shall not exceed the amount of gain recognized to the transferor on the transfer of such property (determined without regard to this section). This paragraph shall not apply to a disposition to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by this chapter.

(4) LIKE KIND EXCHANGES; INVOLUNTARY CONVERSIONS, ETC.—If property is disposed of and gain (determined without regard to this section) is not recognized in whole or in part under section 1031 or 1033, then the amount of gain taken into account by the transferor under subsection (a)(1) shall not exceed the sum of—

(A) the amount of gain recognized on such disposition (determined without regard to this section), plus

(B) the fair market value of property acquired which is not section 1245 property and which is not taken into account under subparagraph (A).

(5) SECTION 1071 AND 1081 TRANSACTIONS.—Under regulations prescribed by the Secretary or his delegate, rules consistent with paragraphs (3) and (4) of this subsection shall apply in the case of transactions described in section 1071 (relating to gain from sale or exchange to effectuate policies of FCC) or section 1081 (relating to exchanges in obedience to SEC orders).

(6) PROPERTY DISTRIBUTED BY A PARTNERSHIP TO A PARTNER.—

(A) IN GENERAL.—For purposes of this section, the basis of section 1245 property distributed by a partnership to a partner shall be deemed to be determined by reference to the adjusted basis of such property to the partnership.

(B) ADJUSTMENTS ADDED BACK.—In the case of any property described in subparagraph (A), for purposes of computing the recomputed basis of such property the amount of the adjustments added back for periods before the distribution by the partnership shall be—

(i) the amount of the gain to which subsection (a) would have applied if such property had been sold by the partnership immediately before the distribution at its fair market value at such time, reduced by

(ii) the amount of such gain to which section 751(b) applied.

(c) ADJUSTMENTS TO BASIS.—The Secretary or his delegate shall prescribe such regulations as he may deem necessary to provide for adjustments to the basis of property to reflect gain recognized under subsection (a).

(d) APPLICATION OF SECTION.—This section shall apply notwithstanding any other provision of this subtitle."

(2) The table of sections for such part IV is amended by adding at the end thereof the following:

Sec. 1245. Gain from dispositions of certain depreciable property.

(b) CHANGE IN METHOD OF DEPRECIATION.—Subsection (e) of section 167 (relating to depreciation) is amended to read as follows:

(e) CHANGE IN METHOD.—

(1) CHANGE FROM DECLINING BALANCE METHOD.—In the absence of an agreement under subsection (d) containing a provision to the contrary, a taxpayer may at any time elect in accordance with regulations prescribed by the Secretary or his delegate to change from the method of depreciation described in subsection (b)(2) to the method described in subsection (b)(1).

(2) CHANGE WITH RESPECT TO SECTION 1245 PROPERTY.—A taxpayer may, on or before the last day prescribed by law (including extensions thereof) for filing his return for his first taxable year beginning after December 31, 1962, and in such manner as the Secretary or his delegate shall by regulations prescribe, elect to change his method of depreciation in respect of section 1245 property (as defined in section 1245(a)(3)) from any declining balance or sum of the years-digits method to the straight line method. An election may be made under this paragraph notwithstanding any provision to the contrary in an agreement under subsection (d).

(c) SALVAGE VALUE OF PERSONAL PROPERTY.—

(1) AMOUNT TAKEN INTO ACCOUNT.—Section 167 (relating to depreciation) is amended by redesignating subsections (f), (g), and (h) as (g), (h), and (i), respectively, and by inserting after subsection (e) the following new subsection:

(f) Salvage Value.—

(1) General rule.—Under regulations prescribed by the Secretary or his delegate, a taxpayer may, for purposes of computing the allowance under subsection (a) with respect to personal property, reduce the amount taken into account as salvage value by an amount which does not exceed 10 percent of the basis of such property (as determined under subsection (g) as of the time as of which such salvage value is required to be determined).

(2) Personal property defined.—For purposes of this subsection, the term "personal property" means depreciable personal property (other than livestock) with a useful life of 3 years or more acquired after the date of the enactment of the Revenue Act of 1962.

(2) Conforming amendments.—

(A) Sections 179(d)(5) and 642(e) are each amended by striking out "167(g)" and inserting in lieu thereof "167(h)".

(B) Section 179(d)(8) is amended by striking out "167(f)" and inserting in lieu thereof "167(g)".

(d) Special Rule for Charitable Contributions of Section 1245 Property.—Section 170 (relating to charitable, etc., contributions and gifts) is amended by redesignating subsections (e) and (f) as (f) and (g), respectively, and by inserting after subsection (d) the following new subsection:

(e) Special Rule for Charitable Contributions of Section 1245 Property.—The amount of any charitable contribution taken into account under this section shall be reduced by the amount which would have been treated as gain to which section 1245(a) applies if the property contributed had been sold at its fair market value (determined at the time of such contribution).

(e) Computation of Taxable Income for Purposes of Limitation on Percentage Depletion Deduction.—Section 613(a) (relating to percentage depletion) is amended by inserting after the second sentence thereof the following new sentence: "For purposes of the preceding sentence, the allowable deductions taken into account with respect to expenses of mining in computing the taxable income from the property shall be decreased by an amount equal to so much of any gain which (1) is treated under section 1245 (relating to gain from disposition of certain depreciable property) as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231, and (2) is properly allocable to the property."

(f) Technical Amendments.—

(1) Special rule for partnerships.—Section 751(c) (relating to definition of "unrealized receivables" for purposes of subchapter K) is amended by adding after paragraph (2) the following:

For purposes of this section and sections 731, 736, and 741, such term also includes section 1245 property (as defined in section 1245 (a)(3)), but only to the extent of the amount which would be treated as gain to which section 1245 (a) would apply if (at the time of the transaction described in this section or section 731, 736, or 741, as the case may be) such property had been sold by the partnership at its fair market value.

(2) Corporate distribution of property.—Subsections (b) and (d) of section 301 (relating to amount distributed) are each amended by striking out "subsection (b) or (c) of section 311" and inserting in lieu thereof "subsection (b) or (c) of section 311 or under section 1245(a)".

(3) Effect on earnings and profits.—Section 312(c)(3) (relating to adjustments of earnings and profits) is amended by strik-

ing out "subsection (b) or (c) of section 311" and inserting in lieu thereof "subsection (b) or (c) of section 311 or under section 1245(a)".

(4) COLLAPSIBLE CORPORATIONS.—Section 341 (e) (relating to collapsible corporations) is amended by inserting after paragraph (11) the following new paragraph:

(12) NONAPPLICATION OF SECTION 1245 (a).—For purposes of this subsection, the determination of whether gain from the sale or exchange of property would under any provision of this chapter be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b) shall be made without regard to the application of section 1245(a).

(5) INSTALLMENT OBLIGATIONS IN CERTAIN LIQUIDATIONS.—

(A) Section 453(d)(4)(A) (relating to distribution of installment obligations in section 332 liquidations) is amended by adding at the end thereof the following new sentence: "If the basis of the property of the liquidating corporation in the hands of the distributee is determined under section 334 (b)(2) then the preceding sentence shall not apply to the extent that under paragraph (1) gain to the distributing corporation would be considered as gain to which section 1245(a) applies."

(B) Section 453(d)(4)(B) (relating to distribution of installment obligations in liquidations to which section 337 applies) is amended by adding at the end thereof the following new sentence: "The preceding sentence shall not apply to the extent that under paragraph (1) gain to the distributing corporation would be considered as gain to which section 1245(a) applies."

(g) EFFECTIVE DATES.—The amendments made by this section (other than the amendments made by subsection (c)) shall apply to taxable years beginning after December 31, 1962. The amendments made by subsection (c) shall apply to taxable years beginning after December 31, 1961, and ending after the date of the enactment of this Act.

SEC. 14. FOREIGN INVESTMENT COMPANIES.

(a) TREATMENT OF SALE OF STOCK OF FOREIGN INVESTMENT COMPANIES.—

(1) IN GENERAL.—Part IV of subchapter P of chapter 1 (relating to special rules for determining capital gains and losses) is amended by adding after section 1245 (as added by section 13 of this Act) the following new sections:

SEC. 1246. GAIN ON FOREIGN INVESTMENT COMPANY STOCK.

(a) TREATMENT OF GAIN AS ORDINARY INCOME.—

(1) GENERAL RULE.—In the case of a sale or exchange (or a distribution which, under section 302 or 331, is treated as an exchange of stock) after December 31, 1962, of stock in a foreign corporation which was a foreign investment company (as defined in subsection (b)) at any time during the period during which the taxpayer held such stock, any gain shall be treated as gain from the sale or exchange of property which is not a capital asset. to the extent of the taxpayer's ratable share of the earnings and profits of such corporation accumulated for taxable years beginning after December 31, 1962.

(2) RATABLE SHARE.—For purposes of this section, the taxpayer's ratable share shall be determined under regulations prescribed by the Secretary or his delegate, but shall include only his ratable share of the accumulated earnings and profits of such corporation—

(A) for the period during which the taxpayer held such stock, but

(B) excluding such earnings and profits attributable to any amount previously included in the gross income of such taxpayer under section 951 (but only to the extent the inclusion of such amount did not result in an exclusion of any other amount from gross income under section 959).

(3) TAXPAYER TO ESTABLISH EARNINGS AND PROFITS.—Unless the taxpayer establishes the amount of the accumulated earnings and profits of the foreign investment company and the ratable share thereof for the period during which the taxpayer held such stock, all the gain from the sale or exchange of stock in such company shall be considered as gain from the sale or exchange of property which is not a capital asset.

(4) HOLDING PERIOD OF STOCK MUST BE MORE THAN 6 MONTHS.—This section shall not apply with respect to the sale or exchange of stock where the holding period of such stock as of the date of such sale or exchange is 6 months or less.

(b) DEFINITION OF FOREIGN INVESTMENT COMPANY.—For purposes of this section, the term "foreign investment company" means any foreign corporation which, for any taxable year beginning after December 31, 1962, is—

(1) registered under the Investment Company Act of 1940, as amended (15 U.S.C. 80a–1 to 80b–2), either as a management company or as a unit investment trust, or

(2) engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities (within the meaning of section 3(a)(1) of such Act, as limited by paragraphs (2) through (10) (except paragraph (6)(C)) and paragraphs (12) through (15) of section 3(c) of such Act) at a time when more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or of the total value of shares of all classes of stock, was held, directly or indirectly (within the meaning of section 958(a)), by United States persons (as defined in section 7701(a)(30)).

(c) STOCK HAVING TRANSFERRED OR SUBSTITUTED BASIS.—To the extent provided in regulations prescribed by the Secretary or his delegate, stock in a foreign corporation, the basis of which (in the hands of the taxpayer selling or exchanging such stock) is determined by reference to the basis (in the hands of such taxpayer or any other person) of stock in a foreign investment company, shall be treated as stock of a foreign investment company and held by the taxpayer throughout the holding period for such stock (determined under section 1223).

(d) RULES RELATING TO ENTITIES HOLDING FOREIGN INVESTMENT COMPANY STOCK.—To the extent provided in regulations prescribed by the Secretary or his delegate—

(1) trust certificates of a trust to which section 677 (relating to income for benefit of grantor) applies, and

(2) stock of a domestic corporation,

shall be treated as stock of a foreign investment company and held by the taxpayer throughout the holding period for such certificates or stock (determined under section 1223) in the same proportion that the investment in stock in a foreign investment company by the trust or domestic corporation bears to the total assets of such trust or corporation.

(e) RULES RELATING TO STOCK ACQUIRED FROM A DECEDENT.—

(1) BASIS.—In the case of stock of a foreign investment company acquired by bequest, devise, or inheritance (or by the decedent's estate) from a decedent dying after December 31, 1962, the basis determined under section 1014 shall be reduced (but not below the adjusted basis of such stock in the hands of the decedent immediately before his death) by the amount of the decedent's ratable share of the earnings and profits of such company accumulated after December 31, 1962. Any stock so acquired shall be treated as stock described in subsection (c).

(2) DEDUCTION FOR ESTATE TAX.—If stock to which subsection (a) applies is acquired from a decedent, the taxpayer shall, under regulations pre-

scribed by the Secretary or his delegate, be allowed (for the taxable year of the sale or exchange) a deduction from gross income equal to that portion of the decedent's estate tax deemed paid which is attributable to the excess of (A) the value at which such stock was taken into account for purposes of determining the value of the decedent's gross estate, over (B) the value at which it would have been so taken into account if such value had been reduced by the amount described in paragraph (1).

(f) Information With Respect to Certain Foreign Investment Companies.—Every United States person who, on the last day of the taxable year of a foreign investment company beginning after December 31, 1962, owns 5 percent or more in value of the stock of such company shall furnish with respect to such company such information as the Secretary or his delegate shall by regulations prescribe.

(g) Cross Reference.—For special rules relating to the earnings and profits of foreign investment companies, see section 312(l).

SEC. 1247. ELECTION BY FOREIGN INVESTMENT COMPANIES TO DISTRIBUTE INCOME CURRENTLY.

(a) Election by Foreign Investment Company.—

(1) In general.—If a foreign investment company which is described in section 1246(b)(1) elects (in the manner provided in regulations prescribed by the Secretary or his delegate) on or before December 31, 1962, with respect to each taxable year beginning after December 31, 1962, to—

(A) distribute to its shareholders 90 percent or more of what its taxable income would be if it were a domestic corporation;

(B) designate in a written notice mailed to its shareholders at any time before the expiration of 45 days after the close of its taxable year the pro rata amount of the excess (determined as if such corporation were a domestic corporation) of the net long-term capital gain over the net short-term capital loss of the taxable year; and the portion thereof which is being distributed; and

(C) provide such information as the Secretary or his delegate deems necessary to carry out the purposes of this section,

then section 1246 shall not apply with respect to the qualified shareholders of such company during any taxable year to which such election applies.

(2) Special rules.—

(A) Computation of taxable income.—For purposes of paragraph (1)(A), the taxable income of the company shall be computed without regard to—

(i) the excess of the net long-term capital gain over the net short-term capital loss referred to in paragraph (1)(B),

(ii) section 172 (relating to net operating losses), and

(iii) any deduction provided by part VIII of subchapter B (other than the deduction provided by section 248, relating to organizational expenditures).

(B) Distributions after the close of the taxable year.—For purposes of paragraph (1)(A), a distribution made after the close of the taxable year and on or before the 15th day of the third month of the next taxable year shall be treated as distributed during the taxable year to the extent elected by the company (in accordance with regulations prescribed by the Secretary or his delegate) on or before the 15th day of such third month.

(C) Carryover of capital losses from nonelection years denied.—In computing the excess of the net long-term capital gain over the net short-term capital loss referred to in paragraph (1)(B), section 1212 shall not apply to losses incurred in or with respect to taxable years before the first taxable year to which the election applies.

(b) Years to Which Election Applies.—The election of any foreign investment company under this section shall terminate as of the close of the taxable year preceding its first taxable year in which any of the following occurs:

(1) the company fails to comply with the provisions of subparagraph (A), (B), or (C) of subsection (a)(1), unless it is shown that such failure is due to reasonable cause and not due to willful neglect,

(2) the company is a foreign personal holding company, or

(3) the company is not a foreign investment company which is described in section 1246(b)(1).

(c) QUALIFIED SHAREHOLDERS.—For purposes of this section—

(1) IN GENERAL.—The term "qualified shareholder" means any shareholder who is a United States person (as defined in section 7701(a)(30)), other than a shareholder described in paragraph (2).

(2) CERTAIN UNITED STATES PERSONS EXCLUDED FROM DEFINITION.—A United States person shall not be treated as a qualified shareholder for the taxable year if for such taxable year (or for any prior taxable year) he did not include, in computing his long-term capital gains in his return for such taxable year, the amount designated by such company pursuant to subsection (a)(1)(B) as his share of the undistributed capital gains of such company for its taxable year ending within or with such taxable year of the taxpayer. The preceding sentence shall not apply with respect to any failure by the taxpayer to treat an amount as provided therein if the taxpayer shows that such failure was due to reasonable cause and not due to willful neglect.

(d) TREATMENT OF DISTRIBUTED AND UNDISTRIBUTED CAPITAL GAINS BY A QUALIFIED SHAREHOLDER.—Every qualified shareholder of a foreign investment company for any taxable year of such company with respect to which an election pursuant to subsection (a) is in effect shall include, in computing his long-term capital gains—

(1) for his taxable year in which received, his pro rata share of the distributed portion of the excess of the net long-term capital gain over the net short-term capital loss for such taxable year of such company, and

(2) for his taxable year in which or with which the taxable year of such company ends, his pro rata share of the undistributed portion of the excess of the net long-term capital gain over the net short-term capital loss for such taxable year of such company.

(e) ADJUSTMENTS.—Under regulations prescribed by the Secretary or his delegate, proper adjustment shall be made—

(1) in the earnings and profits of the electing foreign investment company and a qualified shareholder's ratable share thereof, and

(2) in the adjusted basis of stock of such company held by such shareholder,

to reflect such shareholder's inclusion in gross income of undistributed capital gains.

(f) ELECTION BY FOREIGN INVESTMENT COMPANY WITH RESPECT TO FOREIGN TAX CREDIT.—A foreign investment company with respect to which an election pursuant to subsection (a) is in effect and more than 50 percent of the value (as defined in section 851(c)(4)) of whose total assets at the close of the taxable year consists of stock or securities in foreign corporations may, for such taxable year, elect the application of this subsection with respect to income, war profits, and excess profits taxes described in section 901(b)(1) which are paid by the foreign investment company during such taxable year to foreign countries and possessions of the United States. If such election is made—

(1) the foreign investment company—

(A) shall compute its taxable income, for purposes of subsection (a)(1)(A), without any deductions for income, war profits, or excess profits taxes paid to foreign countries or possessions of the United States, and

(B) shall treat the amount of such taxes, for purposes of subsection (a)(1)(A), as distributed to its shareholders;

(2) each qualified shareholder of such foreign investment company—

(A) shall include in gross income and treat as paid by him his proportionate share of such taxes, and

(B) shall treat, for purposes of applying subpart A of part III of subchapter N, his proportionate share of such taxes as having been paid to the country in which the foreign investment company is incorporated, and

(C) shall treat as gross income from sources within the country in which the foreign investment company is incorporated, for purposes of applying subpart A of part III of subchapter N, the sum of his proportionate share of such taxes and any dividend paid to him by such foreign investment company.

(g) NOTICE TO SHAREHOLDERS.—The amounts to be treated by qualified shareholders, for purposes of subsection (f)(2), as their proportionate share of the taxes described in subsection (f)(1)(A) paid by a foreign investment company shall not exceed the amounts so designated by the foreign investment company in a written notice mailed to its shareholders not later than 45 days after the close of its taxable year.

(h) MANNER OF MAKING ELECTION AND NOTIFYING SHAREHOLDERS.—The election provided in subsection (f) and the notice to shareholders required by subsection (g) shall be made in such manner as the Secretary or his delegate may prescribe by regulations.

(i) LOSS ON SALE OR EXCHANGE OF CERTAIN STOCK HELD LESS THAN 6 MONTHS.—If—

(1) under this section, any qualified shareholder treats any amount designated under subsection (a)(1)(B) with respect to a share of stock as long-term capital gain, and

(2) such share is held by the taxpayer for less than 6 months,

then any loss on the sale or exchange of such share shall, to the extent of the amount described in paragraph (1), be treated as loss from the sale or exchange of a capital asset held for more than 6 months.

(2) The table of sections for such part IV is amended by adding at the end thereof the following:

Sec. 1246. Gain on foreign investment company stock.

Sec. 1247. Election by foreign investment companies to distribute income currently.

(b) CONFORMING AMENDMENTS.—

(1) EARNINGS AND PROFITS OF FOREIGN INVESTMENT COMPANIES.—Section 312 (relating to effect on earnings and profits) is amended by adding after subsection (k) the following new subsection:

(l) EARNINGS AND PROFITS OF FOREIGN INVESTMENT COMPANIES.—

(1) ALLOCATION WITHIN AFFILIATED GROUP.—In the case of a sale or exchange of stock in a foreign investment company (as defined in section 1246 (b)) by a United States person (as defined in section 7701(a)(30)), if such company is a member of an affiliated group, then the accumulated earnings and profits of all members of such affiliated group shall be allocated, under regulations prescribed by the Secretary or his delegate, in such manner as is proper to carry out the purposes of section 1246.

(2) AFFILIATED GROUP DEFINED.—For purposes of paragraph (1) of this subsection, the term "affiliated group" has the meaning assigned to such term by section 1504(a); except that (A) "more than 50 percent" shall be substituted for "80 percent or more", and (B) all corporations shall be treated as includible corporations (without regard to the provisions of section 1504(b)).

(3) PARTIAL LIQUIDATIONS AND REDEMPTIONS.—

(A) IN GENERAL.—If a foreign investment company (as defined in section 1246) distributes amounts in partial liquidation or in a redemption to which section 302(a) or 303 applies, the part of such distribution which is properly chargeable to earnings and profits shall be an amount which is not in excess of the ratable share of the earnings and profits of the company accumulated after February 28, 1913, attributable to the stock so redeemed.

(B) EFFECTIVE DATE.—Subparagraph (A) shall apply only with respect to distributions made after December 31, 1962.

(2) SALE OR EXCHANGE OF INTEREST IN PARTNERSHIP.—Section 751(d)(2) (relating to inventory items which have appreciated substantially in value) is amended by striking out "and" at the end of subparagraph (B), and by striking out subparagraph (C) and inserting in lieu thereof the following new subparagraphs:

(C) any other property of the partnership which, if sold or exchanged by the partnership, would result in a gain taxable under

subsection (a) of section 1246 (relating to gain on foreign investment company stock), and

(D) any other property held by the partnership which, if held by the selling or distributee partner, would be considered property of the type described in subparagraph (A), (B), or (C).

(3) HOLDING PERIOD OF PROPERTY.—Section 1223 (relating to holding period of property) is amended by redesignating paragraph (10) as paragraph (11) and inserting after paragraph (9) the following paragraph:

(10) In determining the period for which the taxpayer has held trust certificates of a trust to which subsection (d) of section 1246 applies, or the period for which the taxpayer has held stock in a corporation to which subsection (d) of section 1246 applies, there shall be included the period for which the trust or corporation (as the case may be) held the stock of foreign investment companies.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to taxable years beginning after December 31, 1962.

SEC. 15. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS.

(a) TREATMENT OF GAIN FROM THE REDEMPTION, CANCELLATION, OR SALE OF STOCK IN CERTAIN FOREIGN CORPORATIONS.—Part IV of subchapter P of chapter 1 (relating to special rules for determining capital gains and losses) is amended by adding after section 1247 (as added by section 14 of this Act) the following new section:

SEC. 1248. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS.

(a) GENERAL RULE.—If—

(1) a United States person sells or exchanges stock in a foreign corporation, or if a United States person receives a distribution from a foreign corporation which, under section 302 or 331, is treated as an exchange of stock, and

(2) such person owns, within the meaning of section 958(a), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation at any time during the 5-year period ending on the date of the sale or exchange when such foreign corporation was a controlled foreign corporation (as defined in section 957).

then the gain recognized on the sale or exchange of such stock shall be included in the gross income of such person as a dividend, to the extent of the earnings and profits of the foreign corporation attributable (under regulations prescribed by the Secretary or his delegate) to such stock which were accumulated in taxable years of such foreign corporation beginning after December 31, 1962, and during the period or periods the stock sold or exchanged was held by such person while such foreign corporation was a controlled foreign corporation.

(b) LIMITATION ON TAX APPLICABLE TO INDIVIDUALS.—In the case of an individual, if the stock sold or exchanged is a capital asset (within the meaning of section 1221) and has been held for more than 6 months, the tax attributable to an amount included in gross income as a dividend under subsection (a) shall not be greater than a tax equal to the sum of—

(1) a pro rata share of the excess of—

(A) the taxes that would have been paid by the foreign corporation with respect to its income had it been taxed under this chapter as a domestic corporation (but without allowance for deduction of, or credit for, taxes described in subparagraph (B)), for the period or periods the stock sold or exchanged was held by the United States person in taxable years beginning after December 31, 1962, while the foreign corporation was a controlled foreign corporation, adjusted for distributions and amounts previously included in gross income of a United States shareholder under section 951, over

(B) the income, war profits, or excess profits taxes paid by the foreign corporation with respect to such income; and

(2) an amount equal to the tax that would result by including in gross income, as gain from the sale or exchange of a capital asset held for more than 6 months, an amount equal to the excess of (A) the amount included in gross income as a dividend under subsection (a), over (B) the amount determined under paragraph (1).

(c) DETERMINATION OF EARNINGS AND PROFITS.—

(1) IN GENERAL.—For purposes of this section, the earnings and profits of any foreign corporation for any taxable year shall be determined according to rules substantially similar to those applicable to domestic corporations, under regulations prescribed by the Secretary or his delegate.

(2) EARNINGS AND PROFITS OF SUBSIDIARIES OF FOREIGN CORPORATIONS.—If—

(A) subsection (a) applies to a sale or exchange by a United States person of stock of a foreign corporation and, by reason of the ownership of the stock sold or exchanged, such person owned within the meaning of section 958(a)(2) stock of any other foreign corporation; and

(B) such person owned, within the meaning of section 958(a), or was considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such other foreign corporation at any time during the 5-year period ending on the date of the sale or exchange when such other foreign corporation was a controlled foreign corporation (as defined in section 957).

then, for purposes of this section, the earnings and profits of the foreign corporation the stock of which is sold or exchanged which are attributable to the stock sold or exchanged shall be deemed to include the earnings and profits of such other foreign corporation which—

(C) are attributable (under regulations prescribed by the Secretary or his delegate) to the stock of such other foreign corporation which such person owned within the meaning of section 958(a)(2) (by reason of his ownership within the meaning of section 958(a)(1)(A) of the stock sold or exchanged) on the date of such sale or exchange; and

(D) were accumulated in taxable years of such other corporation beginning after December 31, 1962, and during the period or periods—

(i) such other corporation was a controlled foreign corporation, and

(ii) such person owned within the meaning of section 958(a)(2) the stock of such other foreign corporation.

(d) EXCLUSIONS FROM EARNINGS AND PROFITS.—For purposes of this section, the following amounts shall be excluded, with respect to any United States person, from the earnings, and profits of a foreign corporation:

(1) AMOUNTS INCLUDED IN GROSS INCOME UNDER SECTION 951.—Earnings and profits of the foreign corporation attributable to any amount previously included in the gross income of such person under section 951, with respect to the stock sold or exchanged, but only to the extent the inclusion of such amount did not result in an exclusion of an amount from gross income under section 959.

(2) GAIN REALIZED FROM THE SALE OR EXCHANGE OF PROPERTY IN PURSUANCE OF A PLAN OF COMPLETE LIQUIDATION.—If a foreign corporation adopts a plan of complete liquidation in a taxable year of a foreign corporation beginning after December 31, 1962, and if section 337(a) would apply if such foreign corporation were a domestic corporation, earnings and profits of the foreign corporation attributable (under regulations prescribed by the Secretary or his delegate) to any net gain from the sale or exchange of property.

(3) LESS DEVELOPED COUNTRY CORPORATIONS.—Earnings and profits accumulated by a foreign corporation while it was a less developed country corporation (as defined in section 902(d), if the stock sold or exchanged was owned for a continuous period of at least 10 years, ending with the date of the sale or exchange, by the United States person who sold or exchanged such stock. In the case of stock sold or exchanged by a corpora-

tion, if United States persons who are individuals, estates, or trusts (each of whom owned within the meaning of section 958(a), or were considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such corporation) owned, or were considered as owning, at any time during the 10-year period ending on the date of the sale or exchange more than 50 percent of the total combined voting power of all classes of stock entitled to vote of such corporation, this paragraph shall apply only if such United States persons owned, or were considered as owning, at all times during the remainder of such 10-year period more than 50 percent of the total combined voting power of all classes of stock entitled to vote of such corporation. For purposes of this paragraph, stock owned by a United States person who is an individual, estate, or trust which was acquired by reason of the death of the predecessor in interest of such United States person shall be considered as owned by such United States person during the period such stock was owned by such predecessor in interest, and during the period such stock was owned by any other predecessor in interest if between such United States person and such other predecessor in interest there was no transfer other than by reason of the death of an individual.

(4) UNITED STATES INCOME.—Any item includible in gross income of the foreign corporation under this chapter as income derived from sources within the United States of a foreign corporation engaged in trade or business in the United States.

(5) AMOUNTS INCLUDED IN GROSS INCOME UNDER SECTION 1247.—If the United States person whose stock is sold or exchanged was a qualified shareholder (as defined in section 1247(c)) of a foreign corporation which was a foreign investment company (as described in section 1246(b)(1)), the earnings and profits of the foreign corporation for taxable years in which such person was a qualified shareholder.

(e) SALES OR EXCHANGES OF STOCK IN CERTAIN DOMESTIC CORPORATIONS.—Under regulations prescribed by the Secretary or his delegate, if—

(1) a United States person sells or exchanges stock of a domestic corporation, or receives a distribution from a domestic corporation which, under section 302 or 331, is treated as an exchange of stock, and

(2) such domestic corporation was informed or availed of principally for the holding, directly or indirectly, of stock of one or more foreign corporations,

such sale or exchange shall, for purposes of this section, be treated as a sale or exchange of the stock of the foreign corporation or corporations held by the domestic corporation.

(f) EXCEPTIONS.—This section shall not apply to—

(1) distributions to which section 303 (relating to distributions in redemption of stock to death taxes) applies;

(2) gain realized on exchanges to which section 356 (relating to receipt of additional consideration in certain reorganizations) applies; or

(3) any amount to the extent that such amount is, under any other provision of this title, treated as—

(A) a dividend,

(B) gain from the sale of an asset which is not a capital asset, or

(C) gain from the sale of an asset held for not more than 6 months.

(g) TAXPAYER TO ESTABLISH EARNINGS AND PROFITS.—Unless the taxpayer establishes the amount of the earnings and profits of the foreign corporation to be taken into account under subsection (a), all gain from the sale or exchange shall be considered a dividend under subsection (a), and unless the taxpayer establishes the amount of foreign taxes to be taken into account under subsection (b), the limitation of such subsection shall not apply.

(b) CLERICAL AMENDMENT.—The table of sections for such part IV is amended by adding at the end thereof the following:

Sec. 1248. Gain from certain sales or exchanges of stock in certain foreign corporations.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to sales or exchanges occurring after December 31, 1962.

SEC. 16. SALES AND EXCHANGES OF PATENTS, ETC., TO CERTAIN FOREIGN CORPORATIONS.

(a) TREATMENT OF GAIN AS ORDINARY INCOME.—Part IV of subchapter P of chapter 1 (relating to special rules for determining capital gains and losses) is amended by adding after section 1248 (as added by section 15 of this Act) the following new section:

SEC. 1249. GAIN FROM CERTAIN SALES OR EXCHANGES OF PATENTS, ETC., TO FOREIGN CORPORATIONS.

(a) GENERAL RULE.—Except as provided in subsection (c), gain from the sale or exchange after December 31, 1962, of a patent, an invention, model, or design (whether or not patented), a copyright, a secret formula or process, or any other similar property right to any foreign corporation by any United States person (as defined in section 7701(a)(30)) which controls such foreign corporation shall, if such gain would (but for the provisions of this subsection) be gain from the sale or exchange of a capital asset or of property described in section 1231, be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

(b) CONTROL.—For purposes of subsection (a), control means, with respect to any foreign corporation, the ownership, directly or indirectly, of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote. For purposes of this subsection, the rules for determining ownership of stock prescribed by section 958 shall apply.

(b) CLERICAL AMENDMENT.—The table of sections for such part IV is amended by adding at the end thereof the following:

Sec. 1249. Gain from certain sales or exchanges of patents, etc., to foreign corporations.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years, beginning after December 31, 1962.

SEC. 17. TAX TREATMENT OF COOPERATIVES AND PATRONS.

(a) IN GENERAL.—Chapter 1 (relating to normal taxes and surtaxes) is amended by adding at the end thereof the following new subchapter:

Subchapter T—Cooperatives and Their Patrons

Part I. Tax treatment of cooperatives.
Part II. Tax treatment by patrons of patronage dividends.
Part III. Definitions: special rules.

PART I—TAX TREATMENT OF COOPERATIVES

Sec. 1381. Organizations to which part applies.
Sec. 1382. Taxable income of cooperatives.
Sec. 1383. Computation of tax where cooperatives redeems nonqualified written notices of allocation.

SEC. 1381. ORGANIZATIONS TO WHICH PART APPLIES.

(a) IN GENERAL.—This part shall apply to—

(1) any organization exempt from tax under section 521 (relating to exemption of farmers' cooperatives from tax), and

(2) any corporation operating on a cooperative basis other than an organization—

(A) which is exempt from tax under this chapter,

(B) which is subject to the provisions of—

(i) part II of subchapter H (relating to mutual saving banks, etc.), or

(ii) subchapter L (relating to insurance companies), or

(C) which is engaged in furnishing electric energy, or providing telephone service, to persons in rural areas.

(b) Tax on Certain Farmers' Cooperatives.—An organization described in subsection (a) (1) shall be subject to the taxes imposed by section 11 or 1201.

SEC. 1382. TAXABLE INCOME OF COOPERATIVES.

(a) Gross Income.—Except as provided in subsection (b), the gross income of any organization to which this part applies shall be determined without any adjustment (as a reduction in gross receipts, an increase in cost of goods sold, or otherwise) by reason of any allocation or distribution to a patron out of the net earnings of such organization.

(b) Patronage Dividends.—In determining the taxable income of an organization to which this part applies, there shall not be taken into account amounts paid during the payment period for the taxable year—

(1) as patronage dividends (as defined in section 1388(a)), to the extent paid in money, qualified written notices of allocation (as defined in section 1388(c)), or other property (except nonqualified written notices of allocation (as defined in section 1388(d)) with respect to patronage occurring during such taxable year; or

(2) in money or other property (except written notices of allocation) in redemption of a nonqualified written notice of allocation which was paid as a patronage dividend during the payment period for the taxable year during which the patronage occurred.

For purposes of this title, any amount not taken into account under the preceding sentence shall be treated in the same manner as an item of gross income and as a deduction therefrom.

(c) Deduction for Nonpatronage Distributions, etc.—In determining the taxable income of an organization described in section 1381(a) (1), there shall be allowed as a deduction (in addition to other deductions allowable under this chapter)—

(1) amounts paid during the taxable year as dividends on its capital stock; and

(2) amounts paid during the payment period for the taxable year—

(A) in money, qualified written notices of allocation, or other property (except nonqualified written notices of allocation) on a patronage basis to patrons with respect to its earnings during such taxable year which are derived from business done for the United States or any of its agencies or from sources other than patronage, or

(B) in money or other property (except written notices of allocation) in redemption of a nonqualified written notice of allocation which was paid, during the payment period for the taxable year during which the earnings were derived, on a patronage basis to a patron with respect to earnings derived from business or sources described in subparagraph (A).

(d) Payment Peroid for Each Taxable Year.—For purposes of subsections (b) and (c) (2), the payment period for any taxable year is the period beginning with the first day of such taxable year and ending with the fifteenth day of the ninth month following the close of such year. For purposes of subsections (b) (1) and (c) (2) (A), a qualified check issued during the payment period shall be treated as an amount paid in money during such period if endorsed and cashed on or before the 90th day after the close of such period.

(e) Products Marketed Under Pooling Arrangements.—For purposes of subsection (b), in the case of a pooling arrangement for the marketing of products, the patronage shall (to the extent provided in regulations prescribed by the Secretary or his delegate) be treated as patronage occurring during the taxable year in which the pool closes.

(f) Treatment of Earnings Received After Patronage Occurred.—If any portion of the earnings from business done with or for patrons is includible in the organization's gross income for a taxable year after the taxable year during which the patronage occurred, then for purposes of applying subsection (b) to such portion the patronage shall, to the extent provided in regulations prescribed by the Secretary or his delegate, be considered to have occurred during the taxable year of the organization during which such earnings are includible in gross income.

SEC. 1383. COMPUTATION OF TAX WHERE COOPERATIVE REDEEMS NONQUALIFIED WRITTEN NOTICES OF ALLOCATION.

(a) General Rule.—If, under section 1382(b)(2) or (c)(2)(B), a deduction is allowable to an organization for the taxable year for amounts paid in redemption of nonqualified written notices of allocation, then the tax imposed by this chapter on such organization for the taxable year shall be the lesser of the following:

(1) the tax for the taxable year computed with such deduction; or

(2) an amount equal to—

(A) the tax for the taxable year computed without such deduction, minus

(B) the decrease in tax under this chapter for any prior taxable year (or years) which would result solely from treating such nonqualified written notices of allocation as qualified written notices of allocation.

(b) Special Rules.—

(1) If the decrease in tax ascertained under subsection (a)(2)(B) exceeds the tax for the taxable year (computed without the deduction described in subsection (a)) such excess shall be considered to be a payment of tax on the last day prescribed by law for the payment of tax for the taxable year, and shall be refunded or credited in the same manner as if it were an overpayment for such taxable year.

(2) For purposes of determining the decrease in tax under subsection (a)(2)(B), the stated dollar amount of any nonqualified written notice of allocation which is to be treated under such subsection as a qualified written notice of allocation shall be the amount paid in redemption of such written notice of allocation which is allowable as a deduction under section 1382 (b)(2) or (c)(2)(B) for the taxable year.

(3) If the tax imposed by this chapter for the taxable year is the amount determined under subsection (a)(2), then the deduction described in subsection (a) shall not be taken into account for any purpose of this subtitle other than for purposes of this section.

PART II—TAX TREATMENT BY PATRONS OF PATRONAGE DIVIDENDS

SEC. 1385. AMOUNTS INCLUDIBLE IN PATRON'S GROSS INCOME.

(a) General Rule.—Except as otherwise provided in subsection (b), each person shall include in gross income—

(1) the amount of any patronage dividend which is paid in money, a qualified written notice of allocation, or other property (except a nonqualified written notice of allocation), and which is received by him during the taxable year from an organization described in section 1381(a), and

(2) any amount, described in section 1382(c)(2)(A) (relating to certain nonpatronage distributions by tax-exempt farmers' cooperatives), which is paid in money, a qualified written notice of allocation, or other property (except a nonqualified written notice of allocation), and which is received by him during the taxable year from an organization described in section 1381(a)(1).

(b) Exclusion From Gross Income.—Under regulations prescribed by the Secretary or his delegate, the amount of any patronage dividend, and any amount received on the redemption, sale, or other disposition of a nonqualified written notice of allocation which was paid as a patronage dividend, shall not be included in gross income to the extent that such amount—

(1) is properly taken into account as an adjustment to basis of property, or

(2) is attributable to personal, living, or family items.

(c) Treatment of Certain Nonqualified Written Notices of Allocation.—

(1) Application of subsection.—This subsection shall apply to any nonqualified written notice of allocation which—

(A) was paid as a patronage dividend, or

(B) was paid by an organization described in section 1381(a)(1) on a patronage basis with respect to earnings derived from business or sources described in section 1382(c)(2)(A).

(2) Basis; amount of gain.—In the case of any nonqualified written notice of allocation to which this subsection applies, for purposes of this chapter—

(A) the basis of such written notice of allocation in the hands of the patron to whom such written notice of allocation was paid shall be zero,

(B) the basis of such written notice of allocation which was acquired from a decedent shall be its basis in the hands of the decedent, and

(C) gain on the redemption, sale, or other disposition of such written notice of allocation by any person shall, to the extent that the stated dollar amount of such written notice of allocation exceeds its basis, be considered as gain from the sale or exchange of property which is not a capital asset.

PART III—DEFINITIONS; SPECIAL RULES

SEC. 1388. DEFINITIONS; SPECIAL RULES.

(a) Patronage Dividend.—For purposes of this subchapter, the term "patronage dividend" means an amount paid to a patron by an organization to which part I of this subchapter applies—

(1) on the basis of quantity or value of business done with or for such patron,

(2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and

(3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.

(b) Written Notice of Allocation.—For purposes of this subchapter, the term "written notice of allocation" means any capital stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice, which discloses to the recipient the stated dollar amount allocated to him by the organization and the portion thereof, if any, which constitutes a patronage dividend.

(c) Qualified Written Notice of Allocation.—

(1) Defined.—For purposes of this subchapter, the term "qualified written notice of allocation" means—

(A) a written notice of allocation which may be redeemed in cash at its stated dollar amount at any time within a period beginning on the date such written notice of allocation is paid and ending not earlier than 90 days from such date, but only if the distributee receives written notice of the right of redemption at the time he receives such written notice of allocation; and

(B) a written notice of allocation which the distributee has consented, in the manner provided in paragraph (2), to take into account at its stated dollar amount as provided in section 1385(a).

Such term does not include any written notice of allocation which is paid as part of a patronage dividend or as part of a payment described in section 1382(c)(2)(A), unless 20 percent or more of the amount of such patronage dividend, or such payment, is paid in money or by qualified check.

(2) Manner of obtaining consent.—A distributee shall consent to take a written notice of allocation into account as provided in paragraph (1)(B) only by—

(A) making such consent in writing,

(B) obtaining or retaining membership in the organization after—

(i) such organization has adopted (after the date of the enactment of the Revenue Act of 1962) a bylaw providing that membership in the organization constitutes such consent, and

(ii) he has received a written notification and copy of such bylaw, or

(C) if neither subparagraph (A) nor (B) applies, endorsing and cashing a qualified check, paid as a part of the patronage dividend or payment of which such written notice of allocation is also a part, on or before the 90th day after the close of the payment period for the taxable year of the organization for which such patronage dividend or payment is paid.

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(3) Period for which consent is effective.—

(A) General rule.—Except as provided in subparagraph (B)—

(i) a consent described in paragraph (2)(A) shall be a consent with respect to all patronage of the distributee with the organization occurring (determined with the application of section 1382(e) during the taxable year of the organization during which such consent is made and all subsequent taxable years of the organization; and

(ii) a consent described in paragraph (2)(B) shall be a consent with respect to all patronage of the distributee with the organization occurring (determined without the application of section 1382(e)) after he received the notification and copy described in paragraph (2)(B)(ii).

(B) Revocation, etc.—

(i) Any consent described in paragraph (2)(A) may be revoked (in writing) by the distributee at any time. Any such revocation shall be effective with respect to patronage occurring on or after the first day of the first taxable year of the organization beginning after the revocation is filed with such organization; except that in the case of a pooling arrangement described in section 1382(e), a revocation made by a distributee shall not be effective as to any pool with respect to which the distributee has been a patron before such revocation.

(ii) Any consent described in paragraph (2)(B) shall not be effective with respect to any patronage occurring (determined without the application of section 1382(e)) after the distributee ceases to be a member of the organization or after the bylaws of the organization cease to contain the provision described in paragraph (2)(B)(i).

(4) Qualified check.—For the purposes of this subchapter, the term "qualified check" means only a check (or other instrument which is redeemable in money) which is paid as a part of a patronage dividend, or as a part of a payment described in section 1382(c)(2)(A), to a distributee who has not given consent as provided in paragraph (2) (A) or (B) with respect to such patronage dividend or payment, and on which there is clearly imprinted a statement that the endorsement and cashing of the check (or other instrument) constitutes the consent of the payee to include in his gross income, as provided in the Federal income tax laws, the stated dollar amount of the written notice of allocation which is a part of the patronage dividend or payment of which such qualified check is also a part. Such term does not include any check (or other instrument) which is paid as part of a patronage dividend or payment which does not include a written notice of allocation (other than a written notice of allocation described in paragraph (1)(A)).

(d) Nonqualified Written Notice of Allocation.—For purposes of this subchapter, the term "nonqualified written notice of allocation" means a written notice of allocation which is not described in subsection (c) or a qualified check which is not cashed on or before the 90th day after the close of the payment period for the taxable year for which the distribution of which it is a part is paid.

(e) Determination of Amount Paid or Received.—For purposes of this subchapter, in determining amounts paid or received—

(1) property (other than a written notice of allocation) shall be taken into account at its fair market value, and

(2) a qualified written notice of allocation shall be taken into account at its stated dollar amount.

(b) Technical Amendments.—

(1) Section 521(a) (relating to exemption of farmers' cooperatives from tax) is amended by striking out "section 522" each place it appears therein and inserting in lieu thereof "part I of subchapter T (sec. 1381 and following)".

(2) Section 522 (relating to tax on farmers' cooperatives) is hereby repealed.

(3) Section 6072(d) (relating to time for filing income tax returns of exempt cooperative associations) is amended to read as follows:

(d) RETURNS OF COOPERATIVE ASSOCIATIONS.—In the case of an income tax return of—

(1) an exempt cooperative association described in section 1381(a)(1), or

(2) an organization described in section 1381(a)(2) which is under an obligation to pay patronage dividends (as defined in section 1388(a)) in an amount equal to at least 50 percent of its net earnings from business done with or for its patrons, or which paid patronage dividends in such an amount out of the net earnings from business done with or for patrons during the most recent taxable year for which it had such net earnings,

a return made on the basis of a calendar year shall be filed on or before the 15th day of September following the close of the calendar year, and a return made on the basis of a fiscal year shall be filed on or before the 15th day of the 9th month following the close of the fiscal year.

(4) The table of subchapters for chapter 1 is amended by adding at the end thereof the following:

SUBCHAPTER T. Cooperatives and their patrons.

(5) The table of sections for part III of subchapter F of chapter 1 is amended by striking out the last line thereof.

(c) EFFECTIVE DATES.—

(1) FOR THE COOPERATIVES.—Except as provided in paragraph (3), the amendments made by subsections (a) and (b) shall apply to taxable years of organizations described in section 1381(a) of the Internal Revenue Code of 1954 (as added by subsection (a)) beginning after December 31, 1962.

(2) FOR THE PATRONS.—Except as provided in paragraph (3), section 1385 of the Internal Revenue Code of 1954 (as added by subsection (a)) shall apply with respect to any amount received from any organization described in section 1381(a) of such Code, to the extent that such amount is paid by such organization in a taxable year of such organization beginning after December 31, 1962.

(3) APPLICATION OF EXISTING LAW.—In the case of any money, written notice of allocation, or other property paid by any organization described in section 1381(a)—

(A) before the first day of the first taxable year of such organization beginning after December 31, 1962, or

(B) on or after such first day with respect to patronage occurring before such first day,

the tax treatment of such money, written notice of allocation, or other property (including the tax treatment of gain or loss on the redemption, sale, or other disposition of such written notice of allocation) by any person shall be made under the Internal Revenue Code of 1954 without regard to subchapter T of chapter 1 of such Code.

SEC. 18. INCLUSION OF FOREIGN REAL PROPERTY IN GROSS ESTATE.

(a) AMENDMENTS TO INCLUDE FOREIGN REAL PROPERTY.—

(1) Section 2031(a) (relating to definition of gross estate) is amended by striking out ", except real property situated outside of the United States".

(2) The following provisions of chapter 11 (imposing an estate tax) are amended by striking out "(except real property situated outside of the United States)":

(A) section 2033 (relating to property in which the decedent had an interest),

(B) section 2034 (relating to dower or curtesy interests),

(C) section 2035(a) (relating to transactions in contemplation of death),

(D) section 2036(a) (relating to transfers with retained life estate),

(E) section 2037(a) (relating to transfers taking effect at death),

(F) section 2038(a) (relating to revocable transfers),

(G) section 2040 (relating to joint interests), and

(H) section 2041(a) (relating to powers of appointment).

(b) Effective Date.—

(1) Except as provided in paragraph (2), the amendments made by subsection (a) shall apply to the estates of decedents dying after the date of the enactment of this Act.

(2) In the case of a decedent dying after the date of the enactment of this Act and before July 1, 1964, the value of real property situated outside of the United States shall not be included in the gross estate (as defined in section 2031(a)) of the decedent—

(A) under section 2033, 2034, 2035(a), 2036(a), 2037(a), or 2038(a) to the extent the real property, or the decedent's interest in it, was acquired by the decedent before February 1, 1962;

(B) under section 2040 to the extent such property or interest was acquired by the decedent before February 1, 1962, or was held by the decedent and the survivor in a joint tenancy or tenancy by the entirety before February 1, 1962; or

(C) under section 2041(a) to the extent that before Febuary 1, 1962, such property or interest was subject to a general power of appointment (as defined in section 2041) possessed by the decedent.

In the case of real property, or an interest therein, situated outside of the United States (including a general power of appointment in respect of such property or interest, and including property held by the decedent and the survivor in a joint tenancy or tenancy by the entirety) which was acquired by the decedent after January 31, 1962, by gift within the meaning of section 2511, or from a prior decedent by devise or inheritance, or by reason of death, form of ownership, or other conditions (including the exercise or nonexercise of a power of appointment), for purposes of this paragraph such property or interest therein shall be deemed to have been acquired by the decedent before February 1, 1962, if before that date the donor or prior decedent had acquired the property or his interest therein or had possessed a power of appointment in respect of the property or interest.

SEC. 19. REPORTING OF INTEREST, DIVIDEND, AND PATRONAGE DIVIDEND PAYMENTS OF $10 OR MORE DURING A YEAR.

(a) Returns Regarding Payment of Dividends.—Section 6042 (relating to returns regarding corporate dividends, earnings, and profits) is amended to read as follows:

SEC. 6042. RETURNS REGARDING PAYMENTS OF DIVIDENDS AND CORPORATE EARNINGS AND PROFITS.

(a) Requirement of Reporting.—

(1) In general.—Every person—

(A) who makes payments of dividends aggregating $10 or more to any other person during any calendar year, or

(B) who receives payments of dividends as a nominee and who makes payments aggregating $10 or more during any calendar year to any other person with respect to the dividends so received.

shall make a return according to the forms or regulations prescribed by the Secretary or his delegate, setting forth the aggregate amount of such payments and the name and address of the person to whom paid.

(2) Returns required by the secretary.—Every person who makes payments of dividends aggregating less than $10 to any other person during any calendar year shall, when required by the Secretary or his delegate, make a return setting forth the aggregate amount of such payments, and the name and address of the person to whom paid.

(b) Dividend Defined.—

(1) General rule.—For purposes of this section, the term "dividend" means—

(A) any distribution by a corporation which is a dividend (as defined in section 316); and

(B) any payment made by a stockbroker to any person as a substitute for a dividend (as so defined).

(2) Exceptions.—For purposes of this section, the term "dividend" does not include—

(A) to the extent provided in regulations prescribed by the Secretary or his delegate, any distribution or payment—

(i) by a foreign corporation, or

(ii) to a foreign corporation, a nonresident alien, or a partnership not engaged in trade or business in the United States and composed in whole or in part of nonresident aliens; and

(B) any amount described in section 1373 (relating to undistributed taxable income of electing small business corporations).

(3) Special rule.—If the person making any payment described in subsection (a)(1) (A) or (B) is unable to determine the portion of such payment which is a dividend or is paid with respect to a dividend, he shall, for purposes of subsection (a)(1), treat the entire amount of such payment as a dividend or as an amount paid with respect to a dividend.

(c) Statements To Be Furnished to Persons With Respect to Whom Information Is Furnished.—Every person making a return under subsection (a)(1) shall furnish to each person whose name is set forth in such return a written statement showing—

(1) the name and address of the person making such return, and

(2) the aggregate amount of payments to the person as shown on such return.

The written statement required under the preceding sentence shall be furnished to the person on or before January 31 of the year following the calendar year for which the return under subsection (a)(1) was made. No statement shall be required to be furnished to any person under this subsection if the aggregate amount of payments to such person as shown on the return made under subsection (a)(1) is less than $10.

(d) Statements To Be Furnished by Corporations to Secretary.—Every corporation shall, when required by the Secretary or his delegate—

(1) furnish to the Secretary or his delegate a statement stating the name and address of each shareholder, and the number of shares owned by each shareholder;

(2) furnish to the Secretary or his delegate a statement of such facts as will enable him to determine the portion of the earnings and profits of the

corporation (including gains, profits, and income not taxed) accumulated during such periods as the Secretary or his delegate may specify, which have been distributed or ordered to be distributed, respectively, to its shareholders during such taxable years as the Secretary or his delegate may specify; and

(3) furnish to the Secretary or his delegate a statement of its accumulated earnings and profits and the names and addresses of the individuals or shareholders who would be entitled to such accumulated earnings and profits if divided or distributed, and of the amounts that would be payable to each.

(b) RETURNS REGARDING PAYMENT OF PATRONAGE DIVIDENDS.—Section 6044 (relating to returns regarding patronage dividends) is amended to read as follows:

SEC. 6044. RETURNS REGARDING PAYMENTS OF PATRONAGE DIVIDENDS.

(a) REQUIREMENT OF REPORTING.—

(1) IN GENERAL.—Except as otherwise provided in this section, every cooperative to which part I of subchapter T of chapter 1 applies, which makes payments of amounts described in subsection (b) aggregating $10 or more to any person during any calendar year, shall make a return according to the forms or regulations prescribed by the Secretary or his delegate, setting forth the aggregate amount of such payments and the name and address of the person to whom paid.

(2) RETURNS REQUIRED BY THE SECRETARY.—Every such cooperative which makes payments of amounts described in subsection (b) aggregating less than $10 to any person during any calendar year shall, when required by the Secretary or his delegate, make a return setting forth the aggregate amount of such payments and the name and address of the person to whom paid.

(b) AMOUNTS SUBJECT TO REPORTING.—

(1) GENERAL RULE.—Except as otherwise provided in this section, the amounts subject to reporting under subsection (a) are—

(A) the amount of any patronage dividend (as defined in section 1388(a)) which is paid in money, qualified written notices of allocation (as defined in section 1388(c)), or other property (except nonqualified written notices of allocation as defined in section 1388(d)),

(B) any amount described in section 1382(c)(2)(A) (relating to certain nonpatronage distributions) which is paid in money, qualified written notices of allocation, or other property (except nonqualified written notices of allocation) by an organization exempt from tax under section 521 (relating to exemption of farmers' cooperatives from tax), and

(C) any amount described in section 1382(b)(2) (relating to redemption of nonqualified written notices of allocation) and, in the case of an organization described in section 1381(a)(1), any amount described in section 1382(c)(2)(B) (relating to redemption of nonqualified written notices of allocation paid with respect to earnings derived from sources other than patronage).

(2) EXCEPTIONS.—The provisions of subsection (a) shall not apply, to the extent provided in regulations prescribed by the Secretary or his delegate, to any payment—

(A) by a foreign corporation, or

(B) to a foreign corporation, a nonresident alien, or a partnership not engaged in trade or business in the United States and composed in whole or in part of nonresident aliens.

(c) EXEMPTION FOR CERTAIN CONSUMER COOPERATIVES.—A cooperative which the Secretary or his delegate determines is primarily engaged in selling at retail goods or services of a type that are generally for personal, living, or family use shall, upon application to the Secretary or his delegate, be granted exemption from the reporting requirements imposed by subsection (a). Application for exemption under this subsection shall be made in accordance with regulations prescribed by the Secretary or his delegate.

(d) DETERMINATION OF AMOUNT PAID.—For purposes of this section, in determining the amount of any payment—

(1) property (other than a qualified written notice of allocation) shall be taken into account at its fair market value, and

(2) a qualified written notice of allocation shall be taken into account at its stated dollar amount.

(e) STATEMENTS TO BE FURNISHED TO PERSONS WITH RESPECT TO WHOM INFORMATION IS FURNISHED.—Every cooperative making a return under subsection (a)(1) shall furnish to each person whose name is set forth in such return a written statement showing—

(1) the name and address of the cooperative making such return, and

(2) the aggregate amount of payments to the person as shown on such return.

The written statement required under the preceding sentence shall be furnished to the person on or before January 31 of the year following the calendar year for which the return under subsection (a)(1) was made. No statement shall be required to be furnished to any person under this subsection if the aggregate amount of payments to such person as shown on the return made under subsection (a)(1) is less than $10.

(c) RETURNS REGARDING PAYMENT OF INTEREST.—Subpart B of part III of subchapter A of chapter 61 (relating to information returns) is amended by adding after section 6048 (as added by section 7(f) of this Act) the following new section:

SEC. 6049. RETURNS REGARDING PAYMENTS OF INTEREST.

(a) REQUIREMENT OF REPORTING.—

(1) IN GENERAL.—Every person—

(A) who makes payments of interest (as defined in subsection (b)) aggregating $10 or more to any other person during any calendar year, or

(B) who receives payments of interest as a nominee and who makes payments aggregating $10 or more during any calendar year to any other person with respect to the interest so received,

shall make a return according to the forms or regulations prescribed by the Secretary or his delegate, setting forth the aggregate amount of such payments and the name and address of the person to whom paid.

(2) RETURNS REQUIRED BY THE SECRETARY.—Every person who makes payments of interest (as defined in subsection (b)) aggregating less than $10 to any person during any calendar year shall, when required by the Secretary or his delegate, make a return setting forth the aggregate amount of such payments and the name and address of the person to whom paid.

(3) OTHER RETURNS REQUIRED BY SECRETARY.—Every corporation making payments, regardless of amounts, of interest other than interest as defined in subsection (b) shall, when required by regulations prescribed by the Secretary or his delegate, make a return according to the forms or regulations prescribed by the Secretary or his delegate, setting forth the amount paid and the name and address of the recipient of each such payment.

(b) INTEREST DEFINED.—

(1) GENERAL RULE.—For purposes of subsections (a) (1) and (2), the term "interest" means—

(A) interest on evidences of indebtedness (including bonds, debentures, notes, and certificates) issued by a corporation in registered form, and, to the extent provided in regulations prescribed by the Secretary or his delegate, interest on other evidences of indebtedness issued by a corporation of a type offered by corporations to the public;

(B) interest on deposits with persons carrying on the banking business;

(C) amounts (whether or not designated as interest) paid by a mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, or similar organization, in respect of deposits, investment certificates, or withdrawable or repurchasable shares;

(D) interest on amounts held by an insurance company under an agreement to pay interest thereon; and

(E) interest on deposits with stockbrokers and dealers in securities.

(2) EXCEPTIONS.—For purposes of subsections (a) (1) and (2), the term "interest" does not include—

(A) interest on obligations described in section 103(a) (1) or (3) (relating to interest on certain governmental obligations);

(B) to the extent provided in regulations prescribed by the Secretary or his delegate, any amount paid by or to a foreign corporation, a nonresident alien, or a partnership not engaged in trade or business in the United States and composed in whole or in part of nonresident aliens; and

(C) any amount on which the person making payment is required to deduct and withhold a tax under section 1451 (relating to tax-free covenant bonds), or would be so required but for section 1451(d) (relating to benefit of personal exemptions).

(c) Statements To Be Furnished to Persons With Respect to Whom Information Is Furnished.—Every person making a return under subsection (a)(1) shall furnish to each person whose name is set forth in such return a written statement showing—

(1) the name and address of the person making such return, and

(2) the aggregate amount of payments to the person as shown on such return.

The written statement required under the preceding sentence shall be furnished to the person on or before January 31 of the year following the calendar year for which the return under subsection (a)(1) was made. No statement shall be required to be furnished to any person under this subsection if the aggregate amount of payments to such person as shown on the return made under subsection (a)(1) is less than $10.

(d) Penalties for Failure To File Information Returns.—Section 6652 (relating to failure to file certain information returns) is amended to read as follows:

SEC. 6652. FAILURE TO FILE CERTAIN INFORMATION RETURNS.

(a) Returns Relating to Payments of Dividends, Interest, and Patronage Dividends.—In the case of each failure to file a statement of the aggregate amount of payments to another person required by section 6042(a)(1) (relating to payments of dividends aggregating $10 or more), section 6044(a)(1) (relating to payments of patronage dividends aggregating $10 or more), or section 6049(a)(1) (relating to payments of interest aggregating $10 or more), on the date prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause and not to willful neglect, there shall be paid (upon notice and demand by the Secretary or his delegate and in the same manner as tax), by the person failing to so file the statement, $10 for each such statement not so filed, but the total amount imposed on the delinquent person for all such failures during any calendar year shall not exceed $25,000.

(b) Other Returns.—In the case of each failure to file a statement of a payment to another person required under authority of section 6041 (relating to certain information at source), section 6042(a)(2) (relating to payments of dividends aggregating less than $10), section 6044(a)(2) (relating to payments of patronage dividends aggregating less than $10), section 6049(a)(2) (relating to payments of interest aggregating less than $10), section 6049 (a)(3) (relating to other payments of interest by corporations), or section 6051(d) (relating to information returns with respect to income tax withheld), on the date prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause and not to willful neglect, there shall be paid (upon notice and demand by the Secretary or his delegate and in the same manner as tax) by the person failing to so file the statement, $1 for each such statement not so filed, but the total amount imposed on the delinquent person for all such failures during the calendar year shall not exceed $1,000.

(c) Alcohol and Tobacco Taxes.—For penalties for failure to file certain information returns with respect to alcohol and tobacco taxes, see, generally, subtitle E.

(e) Penalties for Failure To Furnish Statements to Persons With Respect to Whom Returns Are Filed.—Subchapter B of chapter 68 (relating to assessable penalties) is amended by adding after

section 6677 (as added by section 7(g) of this Act) the following new section:

SEC. 6678. FAILURE TO FURNISH CERTAIN STATEMENTS.

In the case of each failure to furnish a statement under section 6042(c), 6044(e), or 6049(c) on the date prescribed therefor to a person with respect to whom a return has been made under section 6042(a)(1), 6044(a)(1), or 6049(a)(1), respectively, unless it is shown that such failure is due to reasonable cause and not to willful neglect, there shall be paid (upon notice and demand by the Secretary or his delegate and in the same manner as tax), by the person failing to so furnish the statement, $10 for each such statement not so furnished, but the total amount imposed on the delinquent person for all such failures during any calendar year shall not exceed $25,000.

(f) Technical Amendments.—Section 6041 (relating to information at source) is amended—

(1) by striking out, in subsection (a) thereof, "(other than payments described in section 6042(1) or section 6045)" and inserting in lieu thereof "(other than payments to which section 6042(a)(1), 6044(a)(1), or 6049(a)(1) applies, and other than payments with respect to which a statement is required under the authority of section 6042(a)(2), 6044(a)(2), 6045, 6049(a)(2), or 6049(a)(3))"; and

(2) by striking out subsection (c) thereof.

(g) Clerical Amendments.—

(1) The table of sections for subpart B of part III of subchapter A of chapter 61 is amended—

(A) by striking out

Sec. 6042. Returns regarding corporate dividends, earnings, and profits.

and inserting in lieu thereof

Sec. 6042. Returns regarding payments of dividends and corporate earnings and profits.;

(B) by striking out

Sec. 6044. Returns regarding patronage dividends.

and inserting in lieu thereof

Sec. 6044. Returns regarding payments of patronage dividends.;

and

(C) by adding at the end of such table the following:

Sec. 6049. Returns regarding payments of interest.

(2) The table of sections for subchapter B of chapter 68 is amended by adding at the end thereof the following:

Sec. 6678. Failure to furnish certain statements.

(h) Effective Dates.—

(1) Dividends and interest.—The amendments made by this section shall apply to payments of dividends and interest made on or after January 1, 1963.

(2) Patronage dividends.—The amendments made by this section shall apply to payments of amounts described in section 6044(b) of the Internal Revenue Code of 1954 made on or after January 1, 1963, with respect to patronage occurring on or after the first day of the first taxable year of the cooperative beginning on or after January 1, 1963.

SEC. 20. INFORMATION WITH RESPECT TO CERTAIN FOREIGN ENTITIES.

(a) Information To Be Furnished by Individuals, Domestic Corporations, etc., With Respect to Certain Foreign Corporations.—Section 6038 is amended to read as follows:

SEC. 6038. INFORMATION WITH RESPECT TO CERTAIN FOREIGN CORPORATIONS.

(a) Requirement.—

(1) In general.—Every United States person shall furnish, with respect to any foreign corporation which such person controls (within the meaning of subsection (d)(1)), such information as the Secretary or his delegate may prescribe by regulations relating to—

(A) the name, the principal place of business, and the nature of business of such foreign corporation, and the country under whose laws incorporated;

(B) the accumulated profits (as defined in section 902(c)) of such foreign corporation, including the items of income (whether or not included in gross income under chapter 1), deductions (whether or not allowed in computing taxable income under chapter 1), and any other items taken into account in computing such accumulated profits;

(C) a balance sheet for such foreign corporation listing assets, liabilities, and capital;

(D) transactions between such foreign corporation and—

(i) such person,

(ii) any other corporation which such person controls, and

(iii) any United States person owning, at the time the transaction takes place, 10 percent or more of the value of any class of stock outstanding of such foreign corporation; and

(E) a description of the various classes of stock outstanding, and a list showing the name and address of, and number of shares held by, each United States person who is a shareholder of record owning at any time during the annual accounting period 5 percent or more in value of any class of stock outstanding of such foreign corporation.

The Secretary or his delegate may also require the furnishing of any other information which is similar or related in nature to that specified in the preceding sentence.

(2) Period for which information is to be furnished, etc.—The information required under paragraph (1) shall be furnished for the annual accounting period of the foreign corporation ending with or within the United States person's taxable year. The information so required shall be furnished at such time and in such manner as the Secretary or his delegate shall by regulations prescribe.

(3) Limitation.—No information shall be required to be furnished under this subsection with respect to any foreign corporation for any annual accounting period unless such information was required to be furnished under regulations in effect on the first day of such annual accounting period.

(b) Effect of Failure To Furnish Information.—

(1) In general.—If a United States person fails to furnish, within the time prescribed under paragraph (2) of subsection (a), any information with respect to any foreign corporation required under paragraph (1) of subsection (a), then—

(A) in applying section 901 (relating to taxes of foreign countries and possessions of the United States) to such United States person for the taxable year, the amount of taxes (other than taxes reduced under subparagraph (B)) paid or deemed paid (other than those deemed paid under section 904(d)) to any foreign country or possession of the United States for the taxable year shall be reduced by 10 percent, and

(B) in applying sections 902 (relating to foreign tax credit for corporate stockholder in foreign corporation) and 960 (relating to special rules for foreign tax credit) to any such United States person which is a corporation (or to any person who acquires from any other person any portion of the interest of such other person in any such foreign corporation, but only to the extent of such portion) for any taxable year, the amount of taxes paid or deemed paid by each foreign corporation with respect to which such person is required to furnish information during

the annual accounting period or periods with respect to which such information is required under paragraph (2) of subsection (a) shall be reduced by 10 percent.

If such failure continues 90 days or more after notice by the Secretary or his delegate to the United States person, then the amount of the reduction under this paragraph shall be 10 percent plus an additional 5 percent for each 3-month period, or fraction thereof, during which such failure to furnish information continues after the expiration of such 90-day period.

(2) LIMITATION.—The amount of the reduction under paragraph (1) for each failure to furnish information with respect to a foreign corporation required under subsection (a) (1) shall not exceed whichever of the following amounts is the greater:

(A) $10,000, or

(B) the income of the foreign corporation for its annual accounting period with respect to which the failure occurs.

(3) SPECIAL RULES.—

(A) No taxes shall be reduced under this subsection more than once for the same failure.

(B) For purposes of this subsection, the time prescribed under paragraph (2) of subsection (a) to furnish information (and the beginning of the 90-day period after notice by the Secretary) shall be treated as being not earlier than the last day on which (as shown to the satisfaction of the Secretary or his delegate) reasonable cause existed for failure to furnish such information.

(C) In applying subsections (a) and (b) of section 902, and in applying subsection (a) of section 960, the reduction provided by this subsection shall not apply for purposes of determining the amount of accumulated profits in excess of income, war profits, and excess profits taxes.

(c) TWO OR MORE PERSONS REQUIRED TO FURNISH INFORMATION WITH RESPECT TO SAME FOREIGN CORPORATION.—Where, but for this subsection, two or more United States persons would be required to furnish information under subsection (a) with respect to the same foreign corporation for the same period, the Secretary or his delegate may by regulations provide that such information shall be required only from one person. To the extent practicable, the determination of which person shall furnish the information shall be made on the basis of actual ownership of stock.

(d) DEFINITIONS.—For purposes of this section—

(1) CONTROL.—A person is in control of a corporation if such person owns stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or more than 50 percent of the total value of shares of all classes of stock, of a corporation. If a person is in control (within the meaning of the preceding sentence) of a corporation which in turn owns more than 50 percent of the total combined voting power of all classes of stock entitled to vote of another corporation, or owns more than 50 percent of the total value of the shares of all classes of stock of another corporation, then such person shall be treated as in control of such other corporation. For purposes of this paragraph, the rules prescribed by section 318(a) for determining ownership of stock shall apply; except that—

(A) the second sentence of subparagraphs (A) and (B), and clause (ii) of subparagraph (C), of section 318(a)(2) shall not be applied so as to consider a United States person as owning stock which is owned by a person who is not a United States person, and

(B) in applying clause (i) of subparagraph (C) of section 318(a)(2), the phrase "10 percent" shall be substituted for the phrase "50 percent" used in subparagraph (C).

(2) ANNUAL ACCOUNTING PERIOD.—The annual accounting period of a foreign corporation is the annual period on the basis of which such corporation regularly computes its income in keeping its books.

(e) CROSS REFERENCES.—

(1) For provisions relating to penalties for violations of this section, see section 7203.

(2) For definition of the term "United States person", see section 7701(a)(30).

(b) INFORMATION AS TO ORGANIZATION OR REORGANIZATION OF FOREIGN CORPORATIONS AND AS TO ACQUISITIONS OF THEIR STOCK.—Section 6046 (relating to returns as to creation or organization, or reorganization, of foreign corporations) is amended to read as follows:

SEC. 6046. RETURNS AS TO ORGANIZATION OR REORGANIZATION OF FOREIGN CORPORATIONS AND AS TO ACQUISITIONS OF THEIR STOCK.

(a) REQUIREMENT OF RETURN.—A return complying with the requirements of subsection (b) shall be made by—

(1) each United States citizen or resident who is on January 1, 1963, an officer or director of a foreign corporation, 5 percent or more in value of the stock of which is owned by a United States person (as defined in section 7701(a)(30)), or who becomes such an officer or director at any time after such date,

(2) each United States person who on January 1, 1963, owns 5 percent or more in value of the stock of a foreign corporation, or who, at any time after such date—

(A) acquires stock which, when added to any stock owned on January 1, 1963, has a value equal to 5 percent or more of the value of the stock of a foreign corporation, or

(B) acquires an additional 5 percent or more in value of the stock of a foreign corporation, and

(3) each person who at any time after January 1, 1963, becomes a United States person while owning 5 percent or more in value of the stock of a foreign corporation.

(b) FORM AND CONTENTS OF RETURNS.—The returns required by subsection (a) shall be in such form and shall set forth, in respect of the foreign corporation, such information as the Secretary or his delegate prescribes by forms or regulations as necessary for carrying out the provisions of the income tax laws, except that in the case of persons described only in subsection (a)(1) the information required shall be limited to the names and addresses of persons described in subsection (a)(2).

(c) OWNERSHIP OF STOCK.—For purposes of subsection (a), stock owned directly or indirectly by a person (including, in the case of an individual, stock owned by members of his family) shall be taken into account. For purposes of the preceding sentence, the family of an individual shall be considered as including only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

(d) TIME FOR FILING.—Any return required by subsection (a) shall be filed on or before the 90th day after the day on which, under any provision of subsection (a), the United States citizen, resident, or person becomes liable to file such return.

(e) LIMITATION.—

(1) GENERAL RULE.—Except as provided in paragraph (2), no information shall be required to be furnished under this section with respect to any foreign corporation unless such information was required to be furnished under regulations which have been in effect for at least 90 days before the date on which the United States citizen, resident, or person becomes liable to file a return required under subsection (a).

(2) EXCEPTION.—In the case of liability to file a return under subsection (a) arising on or after January 1, 1963, and before June 1, 1963—

(A) no information shall be required to be furnished under this section with respect to any foreign corporation unless such information was required to be furnished under regulations in effect on or before March 1, 1963, and

(B) if the date on which such regulations become effective is later than the day on which such liability arose, any return required by subsection (a) shall (in lieu of the time prescribed by subsection (d)) be filed on or before the 90th day after such date.

(f) CROSS REFERENCE.—For provisions relating to penalties for violations of this section, see sections 6679 and 7203.

(c) CIVIL PENALTY FOR FAILURE TO FILE RETURN.—Subchapter P of chapter 68 (relating to assessable penalties) is amended by adding

after section 6678 (as added by section 19(e) of this Act) the following new section:

SEC. 6679. FAILURE TO FILE RETURNS AS TO ORGANIZATION OR REORGANIZATION OF FOREIGN CORPORATIONS AND AS TO ACQUISITIONS OF THEIR STOCK.

(a) CIVIL PENALTY.—In addition to any criminal penalty provided by law, any person required to file a return under section 6046who fails to file such return at the time provided in such section, or who files a return which does not show the information required pursuant to such section, shall pay a penalty of $1,000, unless it is shown that such failure is due to reasonable cause.

(b) DEFICIENCY PROCEDURES NOT TO APPLY.—Subchapter B of chapter 63 (relating to deficiency procedure for income, estate, and gift taxes) shall not apply in respect of the assessment or collection of any penalty imposed by subsection (a).

(d) TECHNICAL AMENDMENTS.—

(1) Section 318(b) (relating to cross references) is amended by striking out "and" at the end of paragraph (5), by striking out the period at the end of paragraph (6) and inserting in lieu thereof "; and", and by adding at the end thereof the following:

(7) section 6038(d)(1) (relating to information with respect to certain foreign corporations).

(2) The table of sections for subpart B of part III of subchapter A of chapter 61 is amended by striking out

Sec. 6046. Returns as to creation or organization, or reorganization, of foreign corporations.

and inserting in lieu thereof

Sec. 6046. Returns as to organization or reorganization of foreign corporations and as to acquisitions of their stock.

(3) The table of sections for subchapter B of chapter 68 is amended by adding at the end thereof the following:

Sec. 6679. Failure to file returns as to organization or reorganization of foreign corporations and as to acquisitions of their stock.

(e) EFFECTIVE DATE.—

(1) The amendments made by subsection (a) shall apply with respect to annual accounting periods of foreign corporations beginning after December 31, 1962.

(2) The amendments made by subsection (b) shall take effect on January 1, 1963.

SEC. 21. EXPENDITURES BY FARMERS FOR CLEARING LAND.

(a) ALLOWANCE OF DEDUCTION.—Part VI of subchapter B of chapter 1 (relating to itemized deductions for individuals and corporations) is amended by adding after section 181 (as added by section 2(c) of this Act) the following new section:

SEC. 182. EXPENDITURES BY FARMERS FOR CLEARING LAND.

(a) IN GENERAL.—A taxpayer engaged in the business of farming may elect to treat expenditures which are paid or incurred by him during the taxable year in the clearing of land for the purpose of making such land suitable for use in farming as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.

(b) LIMITATION.—The amount deductible under subsection (a) for any taxable year shall not exceed whichever of the following amounts is the lesser:

(1) $5,000, or

(2) 25 percent of the taxable income derived from farming during the taxable year.

For purposes of paragraph (2), the term "taxable income derived from farming" means the gross income derived from farming reduced by the deductions allowed by this chapter (other than by this section) which are attributable to the business of farming.

(c) Definitions.—For purposes of subsection (a)—

(1) The term "clearing of land" includes (but is not limited to) the eradication of trees, stumps, and brush, the treatment or moving of earth, and the diversion of streams and watercourses.

(2) The term "land suitable for use in farming" means land which as a result of the activities described in paragraph (1) is suitable for use by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock.

(d) Exceptions, etc.—

(1) Exceptions.—The expenditures to which subsection (a) applies shall not include—

(A) the purchase, construction, installation, or improvement of structures, appliances, or facilities which are of a character which is subject to the allowance for depreciation provided in section 167, or

(B) any amount paid or incurred which is allowable as a deduction without regard to this section.

(2) Certain property used in the clearing of land.—

(A) Allowance for depreciation.—The expenditures to which subsection (a) applies shall include a reasonable allowance for depreciation with respect to property of the taxpayer which is used in the clearing of land for the purpose of making such land suitable for use in farming and which, if used in a trade or business, would be property subject to the allowance for depreciation provided by section 167.

(B) Treatment as depreciation deduction.—For purposes of this chapter, any expenditure described in subparagraph (A) shall, to the extent allowed as a deduction under subsection (a), be treated as an amount allowed under section 167 for exhaustion, wear and tear, or obsolescence of the property which is used in the clearing of land.

(e) Election.—The election under subsection (a) for any taxable year shall be made within the time prescribed by law (including extensions thereof) for filing the return for such taxable year. Such election shall be made in such manner as the Secretary or his delegate may by regulations prescribe. Such election may not be revoked except with the consent of the Secretary or his delegate.

(b) Conforming Amendment.—Section 263(a)(1) (relating to disallowance of deductions for capital expenditures) is amended by striking out "or" at the end of subparagraph (C), by striking out the period at the end of subparagraph (D) and inserting ", or", and by adding at the end thereof the following new subparagraph:

(E) expenditures by farmers for clearing land deductible under section 182.

(c) Clerical Amendment.—The table of sections for such part VI is amended by adding at the end thereof the following:

Sec. 182. Expenditures by farmers for clearing land.

(d) Effective Date.—The amendments made by this section shall apply with respect to taxable years beginning after December 31, 1962.

SEC. 22. CHARITABLE CONTRIBUTIONS MADE FROM INCOME ATTRIBUTABLE TO SEVERAL TAXABLE YEARS.

(a) Treatment for Purposes of Part I of Subchapter Q.—Section 1307 (relating to rules applicable to part I of subchapter Q) is amended by adding at the end thereof the following new subsection:

(e) Election With Respect to Charitable Contributions.—In the case of an individual who elects (in such manner and at such time as the Secretary

or his delegate prescribes by regulations) to have the provisions of this subsection apply, an amount received or accrued to which this part applies shall be reduced, for purposes of computing the tax liability of the taxpayer under this part with respect to the amount so received or accrued, by an amount equal to that portion of (1) the amount of charitable contributions made by the taxpayer during the taxable year in which the amount is so received or accrued which are allowable as a deduction for such year under section 170 (determined without regard to this part), as (2) the amount received or accrued to which this part applies is of the adjusted gross income for the taxable year (determined without regard to this part). In any case in which the taxpayer elects to have the provisions of the preceding sentence apply, for purposes of computing the limitation on tax under this part—

(1) only the same proportion of the amount to which this part applies shall be taken into account for purposes of computing the limitations under section 170(b)(1) (A) and (B) for taxable years before the taxable year in which such amount is received or accrued as (A) the excess of the maximum amount which could, if the taxpayer had made additional contributions described in clause (i), (ii), or (iii) of section 170(b)(1)(A), have been described in clause (1) of the preceding sentence over the amount described in such clause (1), bears to (B) such maximum amount, and

(2) the portion of the amount of charitable contributions described in the preceding sentence shall not be taken into account in computing the tax for the taxable year in which the amount to which this part applies is received or accrued.

(b) Effective Date.—The amendment made by subsection (a) shall apply with respect to amounts received or accrued in taxable years beginning after December 31, 1961.

SEC. 23. EFFECTIVE DATE OF SECTION 1371(c) OF THE INTERNAL REVENUE CODE OF 1954.

(a) In General.—Subject to the provisions of subsection (b), section 1371(c) of the Internal Revenue Code of 1954 (as added by section 2(a) of the Act entitled "An Act to amend the Internal Revenue Code of 1954 to provide a personal exemption for children placed for adoption and to clarify certain provisions relating to the election of small business corporations as to taxable status", approved September 23, 1959 (Public Law 86–376)), shall (notwithstanding the provisions of the first sentence of section 2(d) of such Act) also apply to taxable years beginning after December 31, 1957, and before January 1, 1960.

(b) Election and Consent by Corporations; Consents by Shareholders.—Subsection (a) shall apply with respect to any corporation and its shareholders only if, within one year after the date of the enactment of this Act—

(1) such corporation (in such manner as the Secretary of the Treasury or his delegate prescribes by regulations) elects to have the provisions of subsection (a) apply and consents to the application of subsection (c); and

(2) each person who is a shareholder of such corporation on the date on which such corporation makes such election, and each person who was a shareholder of such corporation during any taxable year of such corporation beginning after December 31, 1957, and ending before the date of such election, consents (in such manner and at such time as the Secretary of the Treasury or his delegate prescribes by regulations) to such election and to the application of subsection (c).

(c) TOLLING OF STATUTES OF LIMITATIONS.—In any case in which a corporation makes an election under subsection (b)—

(1) if the assessment of any deficiency against the corporation making such election, or any shareholder of such corporation who consents to such election, for any taxable year is prevented, at any time on or before the expiration of one year after the date of such election, by the operation of any law or rule of law, assessment of such deficiency may, nevertheless, be made, to the extent such deficiency is attributable to the application of subsection (a), at any time on or before the expiration of such one-year period; and

(2) if credit or refund of any overpayment of tax by the corporation making such election, or any shareholder of such corporation who consents to such election, for any taxable year is prevented, at any time on or before the expiration of one year after the date of such election, by the operation of any law or rule of law, credit or refund of such overpayment may, nevertheless, be allowed or made, to the extent such overpayment is attributable to the application of subsection (a), if claim therefore is filed on or before the expiration of such one-year period.

SEC. 24. CERTAIN LOSSES SUSTAINED IN CONVERTING FROM STREET RAILWAY TO BUS OPERATIONS.

(a) IN GENERAL.—If a corporation has a net operating loss for the taxable year ending December 31, 1953, or the taxable year ending December 31, 1954, principally as the result of conversion from street railways to bus operations with respect to part or all of the company's operations, then its unused conversion loss will be subject to the treatment provided in subsection (c).

(b) UNUSED CONVERSION LOSS DEFINED.—The amount of the unused conversion loss shall be the sum of the part of the net operating loss for each year described in subsection (a) which (without regard to this section) would be carried over to the sixth taxable year following the loss year if section 172(b) of the Internal Revenue Code of 1954 (or, where applicable, section 122(b)(2)(B) of the Internal Revenue Code of 1939) permitted such a carryover.

(c) TREATMENT OF UNUSED CONVERSION LOSS.—If a taxpayer has an unused conversion loss, then in determining the amount of the net operating loss carryover from the taxable year ending December 31, 1959, to each of the 5 taxable years following such taxable year for purposes of section 172 of the Internal Revenue Code of 1954, such unused conversion loss shall be treated as a net operating loss for the taxable year ending December 31, 1959. This subsection shall apply only for years in which the taxpayer is engaged in the furnishing or sale of transportation (as defined in section 1503(c)(1)(A) of the Internal Revenue Code of 1954).

(d) REGULATIONS.—The Secretary of the Treasury, or his delegate, may prescribe by regulation such rules as may be necessary to carry out the purposes of this section.

SEC. 25. PENSION PLAN OF LOCAL UNION NUMBERED 435, INTERNATIONAL HOD CARRIERS' BUILDING AND COMMON LABORERS' UNION OF AMERICA.

The pension plan of Local Union Numbered 435 of the International Hod Carriers' Building and Common Laborers' Union of America, which was negotiated to take effect May 1, 1960, pursuant to an agreement between such union and the Building Trades Em-

ployers Association of Rochester, New York, Incorporated, and which has been held by the Internal Revenue Service to constitute a qualified trust under section 401(a) of the Internal Revenue Code of 1954, and to be exempt from taxation under section 501(a) of such Code, shall be held and considered to have been a qualified trust under such section 401(a), and to have been exempt from taxation under such section 501(a), for the period beginning May 1, 1960, and ending April 20, 1961, but only if it is shown to the satisfaction of the Secretary of the Treasury or his delegate that the trust has not in this period been operated in a manner which would jeopardize the interests of its beneficiaries.

SEC. 26. CONTINUATION OF A PARTNERSHIP YEAR FOR SURVIVING PARTNER IN A TWO-MAN PARTNERSHIP WHERE ONE DIES.

(a) Close of Taxable Year of Two-Man Partnership When One Partner Dies.—Section 188 of the Internal Revenue Code of 1939 (relating to different taxable years of partner and partnership) is amended—

(1) by striking out "If" and inserting in lieu thereof "(a) General Rule.—If"; and

(2) by adding at the end of such section 188 the following new subsection:

(b) Two-Man Partnership.—For the purpose of this chapter, the death of one of the partners of a partnership consisting of two members shall not, if the surviving partner so elects within one year after the date of enactment of this subsection, result in the termination of the partnership or in the closing of the taxable year of the partnership with respect to the surviving partner prior to the time the partnership year would have closed if neither partner had died or disposed of his interest.

(b) Effective Date, etc.—The amendments made by subsection (a) shall apply with respect to taxable years of a partnership beginning after December 31, 1946, to which the Internal Revenue Code of 1939 applies. If refund or credit of any overpayment resulting from the application of the amendments made by subsection (a) of this section (including interest, additions to the tax, and additional amounts), is prevented on the date of enactment of this Act, or within one year from such date, by the operation of any law or rule of law (other than section 3760 of the Internal Revenue Code of 1939 or section 7121 of the Internal Revenue Code of 1954, relating to closing agreements, and other than section 3761 of the Internal Revenue Code of 1939 or section 7122 of the Internal Revenue Code of 1954, relating to compromises), such refund or credit of such overpayment, may, nevertheless, be made or allowed if claim therefor is filed within one year after the date of the enactment of this Act. No interest shall be allowed or paid on any overpayment resulting from the enactment of this section.

SEC. 27. EXCLUSION FROM GROSS INCOME OF CERTAIN AWARDS MADE PURSUANT TO EVACUATION CLAIMS OF JAPANESE-AMERICAN PERSONS.

(a) In General.—No amount received as an award under the Act entitled "An Act to authorize the Attorney General to adjudicate certain claims resulting from evacuation of certain persons of Japanese ancestry under military orders", approved July 2, 1948, as amended by Public Law 116, Eighty-second Congress, and Public Law 673, Eighty-fourth Congress (50 U.S.C. App., secs. 1981–1987), shall be

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included in gross income for purposes of chapter 1 of the Internal Revenue Code of 1939 or chapter 1 of the Internal Revenue Code of 1954.

(b) Effective Date, etc.—Subsection (a) shall apply with respect to taxable years ending after July 2, 1948. If refund or credit of any overpayment of Federal income tax resulting from the application of subsection (a) (including interest, additions to the tax, additional amounts, and penalties) is prevented on the date of the enactment of this Act, or within one year from such date, by the operation of any law or rule of law, the refund or credit of such overpayment may nevertheless be made or allowed if claim therefor is filed within one year after the date of enactment of this Act. In the case of a claim to which the preceding sentence applies, the amount to be refunded or credited as an overpayment shall not be diminished by any credit or setoff based upon any item other than the amount of the award referred to in subsection (a). No interest shall be allowed or paid on any overpayment resulting from the application of this section.

SEC. 28. DEDUCTION FOR DEPRECIATION BY TENANT-STOCKHOLDER OF COOPERATIVE HOUSING CORPORATION.

(a) Allowance of Deduction.—Section 216 (relating to deductions by tenant-stockholders of a cooperative housing corporation) is amended by—

(1) amending the heading thereof to read as follows:

SEC. 216. DEDUCTION OF TAXES, INTEREST, AND BUSINESS DEPRECIATION BY COOPERATIVE HOUSING CORPORATION TENANT-STOCKHOLDER.; and

(2) adding at the end of section 216 the following new subsection:

(c) Treatment as Property Subject to Depreciation.—So much of the stock of a tenant-stockholder in a cooperative housing corporation as is allocable, under regulations prescribed by the Secretary or his delegate, to a proprietary lease or right of tenancy in property subject to the allowance for depreciation under section 167(a) shall, to the extent such proprietary lease or right of tenancy is used by such tenant-stockholder in a trade or business or for the production of income, be treated as property subject to the allowance for depreciation under section 167(a).

(b) Clerical Amendment.—The table of sections for part VII of subchapter B of chapter 1 is amended by striking out the item relating to section 216 and inserting in lieu thereof the following:

Sec. 216. Deduction of taxes, interest, and business depreciation by cooperative housing corporation tenant-stockholder.

(c) Effective Date.—The amendments made by subsection (a) shall be effective with respect to taxable years beginning after December 31, 1961.

SEC. 29. DEDUCTION FOR INCOME TAX PURPOSES OF CONTRIBUTIONS TO CERTAIN ORGANIZATIONS FOR JUDICIAL REFORM.

For purposes of section 170 of the Internal Revenue Code of 1954 (relating to deduction for charitable, etc., contributions and gifts), a contribution or gift made after December 31, 1961, with respect to a referendum occurring during the calendar year 1962 to or for the use of any nonprofit organization created and operated exclusively—

(1) to consider proposals for the reorganization of the judicial branch of the government of any State of the United States or political subdivision of such State, and

(2) to provide information, make recommendations, and seek public support or opposition as to such proposals,

shall be treated as a charitable contribution if no part of the net earnings of such organization inures to the benefit of any private shareholder or individual. The provisions of the preceding sentence shall not apply to any organization which participates in, or intervenes in, any political campaign on behalf of any candidate for public office.

SEC. 30. EFFECTIVE DATE OF AMENDMENT TO SECTION 1374(b).

The amendment made by section 2(b) of Public Law 86–376 (73 Stat. 699) shall take effect on September 2, 1958.

SEC. 31. TREATIES.

Section 7852(d) of the Internal Revenue Code of 1954 (relating to treaty obligations) shall not apply in respect of any amendment made by this act.

Approved October 16, 1962, 10:30 a.m.

PUBLIC LAW 87–846
EIGHTY-SEVENTH CONGRESS, OCTOBER 22, 1962
H.R. 7283 [18]

An Act to amend the War Claims Act of 1948, as amended, to provide compensation for certain World War II losses.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

TITLE I

SECTION 101. That the War Claims Act of 1948, as amended, is further amended by inserting * * * the following:

* * * * * * *

DEDUCTIONS IN MAKING AWARDS

SEC. 206. (a) In determining the amount of any award there shall be deducted all amounts the claimant has received on account of the same loss or losses with respect to which an award is made under this title.

(b) Each claim in excess of $10,000 filed under this title by a corporation shall include a statement under oath disclosing the aggregate amount of Federal tax benefits derived by such corporation in any prior taxable year or years resulting from any deduction or deductions claimed for the loss or losses with respect to which such claim is filed. In determining the amount of any award where the allowable loss exceeds $10,000 there shall be deducted an amount equal to the aggregate amount of Federal tax benefits so derived by the claimant. For the purposes of this subsection, such Federal tax benefits shall be the aggregate of the amounts by which the claimant's taxes for such year or years under chapters 1, 2A, 2B, 2D, and 2E of the Internal Revenue Code of 1939, or subtitle A of the Internal Revenue Code of 1954 were decreased with respect to such loss or losses. Any payments made on an award reduced by reason of this subsection shall be exempt from Federal income taxes.

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Approved October 22, 1962.

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[18] This publication of the law is restricted to excerpts involving internal revenue matters; House Report No. 2035, page 1177, this Bulletin; Senate Report No. 1112 and Conference Report No. 2513 are not published herein.

PUBLIC LAW 87-858
EIGHTY-SEVENTH CONGRESS, OCTOBER 23, 1962
H.R. 8952 [19]

An Act to amend the provisions of the Internal Revenue Code of 1954 relating to the conditions under which the special constructive sale price rule is to apply for purposes of certain manufacturers excise taxes and relating to the taxation of life insurance companies, and for other purposes.

Be it enacted by the Senate and House off Representatives of the United States of America in Congress assembled,

SECTION 1. CONSTRUCTIVE SALE PRICE

(a) Application of Special Rule.—Section 4216(b)(2)(C) of the Internal Revenue Code of 1954 (relating to special rule for determining constructive sale price) is amended by inserting before "the normal method" the following: "in the case of articles upon which tax is imposed under section 4061(a) (relating to automobiles, trucks, etc.), 4191 (relating to business machines), or 4211 (relating to matches),".

(b) Effective Date.—The amendment made by subsection (a) shall apply with respect to articles sold by the manufacturer, producer, or importer on or after October 1, 1962.

SEC. 2. CONTRIBUTIONS TO FOUNDATIONS FOR CERTAIN STATE COLLEGES AND UNIVERSITIES.

(a) Limitation on Contributions Allowable as Deduction.—Section 170(b)(1)(A) of the Internal Revenue Code of 1954 (relating to limitation on amount of deduction for charitable contributions by individuals) is amended by striking out "or" at the end of clause (ii), by inserting "or" at the end of clause (iii), and by inserting after clause (iii) the following new clause:

> (iv) an organization referred to in section 503(b)(3) organized and operated exclusively to receive, hold, invest, and administer property and to make expenditures to or for the benefit of a college or university which is an organization referred to in clause (ii) of this subparagraph and which is an agency or instrumentality of a State or political subdivision thereof, or which is owned or operated by a State or political subdivision thereof or by an agency or instrumentality of one or more States or political subdivisions.

(b) Technical Amendment.—Section 170(b)(1)(B) of such Code is amended by striking out "any charitable contributions to the organizations described in clauses (i), (ii), and (iii)" and inserting in lieu thereof "any charitable contributions described in subparagraph (A)".

(c) Effective Date.—The amendments made by subsections (a) and (b) shall apply to taxable years beginning after December 31, 1960.

SEC. 3. LIFE INSURANCE COMPANIES.

(a) Variable Annuities and Other Segregated Asset Accounts.—Section 801(g) of the Internal Revenue Code of 1954 (relating to variable annuities) is amended to read as follows:

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[19] House Report No. 1265, page 1177, this Bulletin; Senate Report No. 2109, page 1180, this Bulletin; Conference Report No. 2542, page 1193, this Bulletin.

(g) CONTRACTS WITH RESERVES BASED ON SEGREGATED ASSET ACCOUNTS.—

(1) DEFINITIONS.—

(A) ANNUITY CONTRACTS INCLUDE VARIABLE ANNUITY CONTRACTS.—For purposes of this part, an "annuity contract" includes a contract which provides for the payment of a variable annuity computed on the basis of recognized mortality tables and the investment experience of the company issuing the contract.

(B) CONTRACTS WITH RESERVES BASED ON A SEGREGATED ASSET ACCOUNT.—For purposes of this part, a "contract with reserves based on a segregated asset account" is a contract—

(i) which provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company,

(ii) which provides for the payment of annuities, and

(iii) under which the amounts paid in, or the amount paid as annuities, reflect the investment return and the market value of the segregated asset account.

If a contract ceases to reflect current investment return and current market value, such contract shall not be considered as meeting the requirements of clause (iii) after such cessation.

(2) LIFE INSURANCE RESERVES.—For purposes of subsection (b)(1)(A) of this section, the reflection of the investment return and the market value of the segregated asset account shall be considered an assumed rate of interest.

(3) SEPARATE ACCOUNTING.—For purposes of this part, a life insurance company which issues contracts with reserves based on segregated asset accounts shall separately account for the various income, exclusion, deduction, asset, reserve, and other liability items properly attributable to such segregated asset accounts. For such items as are not accounted for directly, separate accounting shall be made—

(A) in accordance with the method regularly employed by such company, if such method is reasonable, and

(B) in all other cases, in accordance with regulations prescribed by the Secretary or his delegate.

(4) INVESTMENT YIELD.—

(A) IN GENERAL.—For purposes of this part, the policy and other contract liability requirements, and the life insurance company's share of investment yield, shall be separately computed—

(i) with respect to the items separately accounted for in accordance with paragraph (3), and

(ii) excluding the items taken into account under clause (i).

(B) CAPITAL GAINS AND LOSSES.—If, without regard to subparagraph (A), the net short-term capital gain exceeds the net long-term capital loss, such excess shall be allocated between clauses (i) and (ii) of subparagraph (A) in proportion to the respective contributions to such excess of the items taken into account under each such clause.

(5) POLICY AND OTHER CONTRACT LIABILITY REQUIREMENTS.—For purposes of this part—

(A) with respect to life insurance reserves based on segregated asset accounts, the adjusted reserves rate and the current earnings rate for purposes of section 805(b), and the rate of interest assumed by the taxpayer for purposes of sections 805(c) and 809(a)(2), shall be a rate equal to the current earnings rate determined under section 805(b)(2) with respect to the items separately accounted for in accordance with paragraph (3) reduced by the percentage obtained by dividing—

"(i) any amount retained with respect to such reserves by the life insurance company from gross investment income (as defined in section 804(b)) on segregated assets, to the extent such retained amount exceeds the deductions allowable under section 804(c) which are attributable to such reserves, by

(ii) the means of such reserves; and

(B) with respect to reserves based on segregated asset accounts other than life insurance reserves, an amount equal to the product of—

(i) the rate of interest assumed as defined in subparagraph (A), and

(ii) the means of such reserves,

shall be included as interest paid within the meaning of section 805(e)(1).

(6) Increases and decreases in reserves.—For purposes of subsections (a) and (b) of section 810, the sum of the items described in section 810(c) taken into account as of the close of the taxable year shall, under regulations prescribed by the Secretary or his delegate, be adjusted—

(A) by subtracting therefrom an amount equal to the sum of the amounts added from time to time (for the taxable year) to the reserves separately accounted for in accordance with paragraph (3) by reason of appreciation in value of assets (whether or not the assets have been disposed of), and

(B) by adding thereto an amount equal to the sum of the amounts subtracted from time to time (for the taxable year) from such reserves by reason of depreciation in value of assets (whether or not the assets have been disposed of).

The deduction allowable for items described in paragraphs (1) and (7) of section 809(d) with respect to segregated asset accounts shall be reduced to the extent that the amount of such items is increased for the taxable year by appreciation (or decreased to the extent that the amount of such items is decreased for the taxable year by depreciation) not reflected in adjustments under the preceding sentence.

(7) Basis of assets held for qualified pension plan contracts.—In the case of contracts described in subparagraph (A), (B), (C), or (D) of section 805(d)(1), the basis of each asset in a segregated asset account shall (in addition to all other adjustments to basis) be—

(A) increased by the amount of any appreciation in value, and

(B) decreased by the amount of any depreciation in value, to the extent that such appreciation and depreciation are from time to time reflected in the increases and decreases in reserves or other items in paragraph (6) with respect to such contracts.

(8) Additional separate computations.—Under regulations prescribed by the Secretary or his delegate, such additional separate computations shall be made, with respect to the items separately accounted for in accordance with paragraph (3), as may be necessary to carry out the purposes of this subsection and this part.

(b) Tax in Case of Capital Gains.—

(1) Alternative tax.—Paragraph (2) of section 802(a) of such Code (relating to tax in case of capital gains) is amended to read as follows:

(2) Alternative tax in case of capital gains.—If for any taxable year beginning after December 31, 1961, the net long-term capital gain of any life insurance company exceeds the net short-term capital loss, then, in lieu of the tax imposed by paragraph (1), there is hereby imposed a tax (if such tax is less than the tax imposed by such paragraph) which shall consist of the sum of—

(A) a partial tax, computed as provided by paragraph (1), on the life insurance company taxable income determined by reducing the taxable investment income, and the gain from operations, by the amount of such excess, and

(B) an amount equal to 25 percent of such excess.

(2) Taxable investment income.—Paragraph (2) of section 804(a) of such Code (relating to definition of taxable investment income) is amended by striking out "equal to the sum" and inserting in lieu thereof "equal to the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss plus the sum".

(3) GAIN AND LOSS FROM OPERATIONS.—Paragraphs (1) and (2) of section 809(b) of such Code (relating to definitions of gain and loss from operations) are each amended by striking out "and" at the end of subparagraph (A), by redesignating subparagraph (B) as subparagraph (C), and by inserting after subparagraph (A) the following new subparagraph:

(B) the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss; and

(4) CONFORMING AMENDMENTS.—Sections 815(c)(3)(B) and 6501(c)(6) of such Code are each amended by striking out "802(a)(1)" and inserting in lieu thereof "802(a)".

(c) LIMITATION ON CERTAIN DEDUCTIONS.—Section 809(f)(2) of such Code (relating to the application of limitation on certain deductions) is amended to read as follows:

(2) APPLICATION OF LIMITATION.—The limitation provided by paragraph (1) shall apply first to the amount of the deduction under subsection (d)(3), then to the amount of the deduction under subsection (d)(6), and finally to the amount of the deduction under subsection (d)(5).

(d) NEW COMPANIES QUALIFYING FOR 8-YEAR LOSS CARRYOVER.—

(1) IN GENERAL.—Section 812(e)(2)(B) of such Code (relating to nonqualified corporation) is amended by adding immediately after the words "with any other corporation" in the first sentence, the following: "(except a corporation taxable under part II or part III of this subchapter)".

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply with respect to all taxable years beginning after December 31, 1954, except that in the case of a nonqualified corporation, as defined in section 812(e)(2)(B) of the Internal Revenue Code of 1954 as in effect prior to the amendment made by paragraph (1), a loss from operations for a taxable year beginning in 1955 shall not be an operations loss carryover to the year 1961, and there shall be no reduction in the portion of such loss from operations which may be carried to 1962 or 1963 by reason of an offset with respect to the year 1961.

(e) CERTAIN DISTRIBUTIONS OF STOCK OF SUBSIDIARIES.—Section 815(a) of such Code (relating to distributions to shareholders) is amended by adding at the end thereof the following: "Further, for purposes of this section, the term 'distribution' does not include any distribution before January 1, 1964, of the stock of a controlled corporation to which section 355 applies, if such controlled corporation is an insurance company subject to the tax imposed by section 831 and control has been acquired prior to January 1, 1963, in a transaction qualifying as a reorganization under section 368(a)(1)(B)."

(f) EFFECTIVE DATE.—Except as provided in subsection (d)(2), the amendments made by this section shall apply with respect to taxable years beginning after December 31, 1961.

Approved October 23, 1962.

PUBLIC LAW 87–859
EIGHTY-SEVENTH CONGRESS, OCTOBER 23, 1962
H.R. 5260 [20]

An Act to continue for an additional three-year period the existing suspensions of the tax on the first domestic processing of coconut oil, palm oil, palm-kernal oil, and fatty acids, salts combinations, or mixtures thereof.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That—

(1) Section 3 of Public Law 85–235, as amended (71 Stat. 516), approved August 30, 1957 (relating to the temporary suspension of the tax on the first domestic processing of coconut oil); and

(2) Public Law 86–37, as amended (73 Stat. 64), approved May 29, 1959 (relating to the temporary suspension of the tax on the first domestic processing of palm oil, palm-kernel oil, etc.),

are each amended by striking out "June 30, 1963" and inserting in lieu thereof "June 30, 1966".

Approved October 23, 1962.

PUBLIC LAW 87–863
EIGHTY-SEVENTH CONGRESS, OCTOBER 23, 1962
H.R. 10620 [21] [22]

An Act to amend section 213 of the Internal Revenue Code of 1954 to increase the maximum limitations on the amount allowable as a deduction for medical, dental, etc., expenses, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subsection (c) of section 213 of the Internal Revenue Code of 1954 (relating to maximum limitations on deduction for medical, dental, etc., expenses) is amended—

(1) by striking out "$2,500" and inserting in lieu thereof "$5,000",

(2) by striking out "$5,000" and inserting in lieu thereof "$10,000", and

(3) by striking out "$10,000" and inserting in lieu thereof "$20,000".

(b) Subsection (g) of such section (relating to maximum limitation if taxpayer or spouse has attained age 65 and is disabled) is amended—

(1) by striking out "$15,000" each place it appears therein and inserting in lieu thereof "$20,000", and

(2) by striking out "$30,000" and inserting in lieu thereof "$40,000".

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[20] House Report No. 2239, page 1197, this Bulletin; Senate Report No. 2102, page 1198, this Bulletin.

[21] Senate Report No. 2274, page 1208, this Bulletin; Conference Report No. 2555, page 1213, this Bulletin; since House Report No. 2323 is substantially the same as the Senate Report, it is not published herein.

[22] Section 2 was introduced as H.R. 10117; Section 3 was added to H.R. 10117 by the Senate Committee; Sections 5 and 6 were added to H.R. 10117 on the Senate floor; related House Report No. 2317, page 1205, this Bulletin; Senate Report No. 2266, page 1210, this Bulletin. Section 4 was introduced as H.R. 2016; related House Report No. 1254, page 1203, this Bulletin.

(c) The amendments made by subsections (a) and (b) shall apply only with respect to taxable years beginning after December 31, 1961.

Sec. 2. (a) Section 401 of the Internal Revenue Code of 1954 (relating to qualified pension, profit-sharing, and stock bonus plans) is amended by redesignating subsection (h) as subsection (i) and by inserting after subsection (g) the following new subsection:

(h) Medical, etc., Benefits for Retired Employees and Their Spouses and Dependents.—Under regulations prescribed by the Secretary or his delegate, a pension or annuity plan may provide for the payment of benefits for sickness, accident, hospitalization, and medical expenses of retired employees, their spouses and their dependents, but only if—

(1) such benefits are subordinate to the retirement benefits provided by the plan,

(2) a separate account is established and maintained for such benefits,

(3) the employer's contributions to such separate account are reasonable and ascertainable,

(4) it is impossible, at any time prior to the satisfaction of all liabilities under the plan to provide such benefits, for any part of the corpus or income of such separate account to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of such benefits, and

(5) notwithstanding the provisions of subsection (a)(2), upon the satisfaction of all liabilities under the plan to provide such benefits, any amount remaining in such separate account must, under the terms of the plan, be returned to the employer.

(b) Section 404(a)(2) of such Code (relating to employees' annuities) is amended—

(1) by inserting after "purchase of retirement annuities" the following: ", or retirement annuities and medical benefits as described in section 401(h),"; and

(2) by inserting after "such retirement annuities" the following: ", or such retirement annuities and medical benefits".

(c) The amendments made by subsections (a) and (b) shall apply to taxable years beginning after the date of the enactment of this Act.

Sec. 3. Any taxpayer who exercised an option to capitalize intangible drilling and development costs under the regulations recognized and approved by the Congress in H. Con. Res. 50, 79th Congress, or under section 39.23(m)–16 of regulations 118, is hereby granted a new option for the first taxable year ending on or after the date of the enactment of this Act to deduct such costs as expenses. Such new option shall be exercised at the time of filing the income tax return for such first taxable year, but otherwise shall be treated, for all purposes, as an option exercised under, and subject to, section 263(c) of the Internal Revenue Code of 1954 and the regulations prescribed thereunder.

Sec. 4. (a) Section 5123(b) of the Internal Revenue Code of 1954 (relating to application of special tax on retail dealers in liquor where business is conducted in more than one location) is amended by adding at the end thereof the following new paragraph:

(3) Liquor stores operated by States, political subdivisions, etc.—A State, a political subdivision of a State, or the District of Columbia shall not be required to pay more than one special tax as a retail dealer in liquors under section 5121(a) regardless of the number of locations at which such State, political subdivision, or District carries on business as a retail dealer in liquors.

(b) Section 5113(b) of such Code (relating to application of special tax on wholesale dealers in liquor to liquor stores operated by States, political subdivisions, etc.) is amended—

(1) by striking out "or Territory" and "Territory," each place such terms appear, and

(2) by striking out "if such liquor store" and inserting in lieu thereof "if such State, political subdivision, or District".

(c) The amendments made by subsections (a) and (b) of this section shall take effect on July 1, 1962.

SEC. 5. (a) Section 1341(b) of the Internal Revenue Code of 1954 (relating to special rules applicable to computation of tax where taxpayer restores substantial amount held under claim of right) is amended by adding at the end thereof the following new paragraphs:

(4) For purposes of determining whether paragraph (4) or paragraph (5) of subsection (a) applies—

(A) in any case where the deduction referred to in paragraph (4) of subsection (a) results in a net operating loss, such loss shall, for purposes of computing the tax for the taxable year under such paragraph (4), be carried back to the same extent and in the same manner as is provided under section 172; and

(B) in any case where the exclusion referred to in paragraph (5)(B) of subsection (a) results in a net operating loss or capital loss for the prior taxable year (or years), such loss shall, for purposes of computing the decrease in tax for the prior taxable year (or years) under such paragraph (5)(B), be carried back and carried over to the same extent and in the same manner as is provided under section 172 or section 1212, except that no carryover beyond the taxable year shall be taken into account.

(5) For purposes of this chapter, the net operating loss described in paragraph (4)(A) of this subsection, or the net operating loss or capital loss described in paragraph (4)(B) of this subsection, as the case may be, shall (after the application of paragraph (4) or (5) (B) of subsection (a) for the taxable year) be taken into account under section 172 or 1212 for taxable years after the taxable year to the same extent and in the same manner as—

(A) a net operating loss sustained for the taxable year, if paragraph (4) of subsection (a) applied, or

(B) a net operating loss or capital loss sustained for the prior taxable year (or years), if paragraph (5)(B) of subsection (a) applied.

(b) The amendment made by subsection (a) shall be effective with respect to taxable years beginning on or after January 1, 1962.

SEC. 6. (a)(1) Section 7608 of the Internal Revenue Code of 1954 (relating to authority of Internal Revenue enforcement officers) is amended by adding at the end thereof the following new subsection:

(b) ENFORCEMENT OF LAWS RELATING TO INTERNAL REVENUE OTHER THAN SUBTITLE E.—

(1) Any criminal investigator of the Intelligence Division or of the Internal Security Division of the Internal Revenue Service whom the Secretary or his delegate charges with the duty of enforcing any of the criminal provisions of the internal revenue laws or any other criminal provisions of law relating to internal revenue for the enforcement of which the Secretary or his delegate is responsible is, in the performance of his duties, authorized to perform the functions described in paragraph (2).

(2) The functions authorized under this subsection to be performed by an officer referred to in paragraph (1) are—

(A) to execute and serve search warrants and arrest warrants, and serve subpoenas and summonses issued under authority of the United States:

(B) to make arrests without warrant for any offense against the United States relating to the internal revenue laws committed in his

presence, or for any felony cognizable under such laws if he has reasonable grounds to believe that the person to be arrested has committed or is committing any such felony; and

(C) to make seizures of property subject to forfeiture under the internal revenue laws.

(2) Such section is further amended by striking out "Any" and inserting in lieu thereof "(a) ENFORCEMENT OF SUBTITLE E AND OTHER LAWS PERTAINING TO LIQUOR, TOBACCO, AND FIREARMS.—Any".

(b) The amendments made by subsection (a) shall take effect on the day after the date of enactment of this Act.

Approved October 23, 1962.

PUBLIC LAW 87-870
EIGHTY-SEVENTH CONGRESS, OCTOBER 23, 1962
H.R. 12599 [23]

An Act relating to the income tax treatment of terminal railroad corporations and their shareholders, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subchapter B of chapter 1 of the Internal Revenue Code of 1954 (relating to computation of taxable income) is amended by adding at the end thereof the following new part:

PART X—TERMINAL RAILROAD CORPORATIONS AND THEIR SHAREHOLDERS

Sec. 281. Terminal railroad corporations and their shareholders.

SEC. 281. TERMINAL RAILROAD CORPORATIONS AND THEIR SHAREHOLDERS.

(a) COMPUTATION OF TAXABLE INCOME OF TERMINAL RAILROAD CORPORATIONS.—

(1) IN GENERAL.—In computing the taxable income of a terminal railroad corporation—

(A) such corporation shall not be considered to have received or accrued—

(i) the portion of any liability of any railroad corporation, with respect to related terminal services provided by such corporation, which is discharged by crediting such liability with an amount of related terminal income, or

(ii) the portion of any charge which would be made by such corporation for related terminal services provided by it, but which is not made as a result of taking related terminal income into account in computing such charge; and

(B) no deduction otherwise allowable under this chapter shall be disallowed as a result of any discharge of liability described in subparagraph (A)(i) or as a result of any computation of charges in the manner described in subparagraph (A)(ii).

(2) LIMITATION.—In the case of any taxable year ending after the date of the enactment of this section, paragraph (1) shall not apply to the extent that it would (but for this paragraph) operate to create (or increase) a net operating loss for the terminal railroad corporation for the taxable year.

(b) COMPUTATION OF TAXABLE INCOME OF SHAREHOLDERS.—Subject to the limitation in subsection (a)(2), in computing the taxable income of any shareholder of a terminal railroad corporation, no amount shall be considered to have been received or accrued or paid or incurred by such shareholder as a result of any discharge of liability described in subsection (a)(1)(A)(i) or as a result of any computation of charges in the manner described in subsection (a)(1)(A)(ii).

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[23] Senate Report No. 2273, page 1216, this Bulletin; Conference Report No. 2543, page 1233, this Bulletin; since House Report No. 2326 is substantially the same as the Senate Report, it is not published herein.

(c) Agreement Required.—In the case of any taxable year, subsections (a) and (b) shall apply with respect to any discharge of liability described in subsection (a)(1)(A)(i), and to any computation of charges in the manner described in subsection (a)(1)(A)(ii), only if such discharge or computation (as the case may be) was provided for in a written agreement, to which all of the shareholders of the terminal railroad corporation were parties, entered into before the beginning of such taxable year.

(d) Definitions.—For purposes of this section—

(1) Terminal railroad corporation.—The term "terminal railroad corporation" means a domestic railroad corporation which is not a member, other than as a common parent corporation, of an affiliated group (as defined in section 1504) and—

(A) all of the shareholders of which are domestic railroad corporations subject to part I of the Interstate Commerce Act;

(B) the primary business of which is the providing of railroad terminal and switching facilities and services to domestic railroad corporations subject to part I of the Interstate Commerce Act and to the shippers and passengers of such railroad corporations;

(C) a substantial part of the services of which for the taxable year is rendered to one or more of its shareholders; and

(D) each shareholder of which computes its taxable income on the basis of a taxable year beginning or ending on the same day that the taxable year of the terminal railroad corporation begins or ends.

(2) Related terminal income.—The term "related terminal income" means the income (determined in accordance with regulations prescribed by the Secretary or his delegate) of a terminal railroad corporation derived—

(A) from services or facilities of a character ordinarily and regularly provided by terminal railroad corporations for railroad corporations or for the employees, passengers, or shippers of railroad corporations;

(B) from the use by persons other than railroad corporations of portions of a facility, or a service, which is used primarily for railroad purposes;

(C) from any railroad corporation for services or facilities provided by such terminal railroad corporation in connection with railroad operations; and

(D) from the United States in payment for facilities or services in connection with mail handling.

For purposes of subparagraph (B), a substantial addition, constructed after the date of the enactment of this section, to a facility shall be treated as a separate facility.

(3) Related terminal services.—The term "related terminal services" includes only services, and the use of facilities, taken into account in computing related terminal income.

(e) Application to Taxable Years Ending Before the Date of Enactment.—In the case of any taxable year ending before the date of the enactment of this section—

(1) this section shall apply only to the extent that the taxpayer computed on its return, filed at or prior to the time (including extensions thereof) that the return for such taxable year was required to be filed, its taxable income in the manner described in subsection (a) in the case of a terminal railroad corporation, or in the manner described in subsection (b) in the case of a shareholder of a terminal railroad corporation; and

(2) this section shall apply to a taxable year for which the assessment of any deficiency, or for which refund or credit of any overpayment, whichever is applicable, was prevented, on the date of the enactment of this section, by the operation of any law or rule of law (other than section 3760 of the Internal Revenue Code of 1939 or section 7121 of this title, relating to closing agreements, and section 3761 of the Internal Revenue Code of 1939 or section 7122 of this title, relating to compromises), only—

(A) to the extent any overpayment of income tax would result from the recomputation of the taxable income of a terminal railroad corporation in the manner described in subsection (a),

(B) if claim for credit or refund of such overpayment, based upon such recomputation, is filed prior to one year after the date of the enactment of this section,

(C) to the extent that paragraph (1) applies, and

(D) if each shareholder of such terminal railroad corporation consents in writing to the assessment, within such period as may be agreed upon with the Secretary or his delegate, of any deficiency for any year to the extent attributable to the recomputation of its taxable income in the manner described in subsection (b) correlative to its allocable share of the adjustment of taxable income made by the terminal railroad corporation in its recomputation under subparagraph (A).

(f) REGULATIONS.—The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this section.

(b) The table of parts for subchapter B of chapter 1 of such Code is amended by adding at the end thereof the following:

Part X. Terminal railroad corporations and their shareholders.

SEC. 2. (a) The amendments made by the first section of this Act shall apply with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

(b) Provisions having the same effect as section 281 of the Internal Revenue Code of 1954 (as added by the first section of this Act) shall be deemed to be included in the Internal Revenue Code of 1939, effective with respect to all taxable years to which such Code applies.

SEC. 3. (a)(1) Chapter 77 of the Internal Revenue Code of 1954 (relating to miscellaneous provisions) is amended by adding at the end thereof the following new sections:

SEC. 7515. SPECIAL STATISTICAL STUDIES AND COMPILATIONS AND OTHER SERVICES ON REQUEST.

The Secretary or his delegate is authorized within his discretion, upon written request, to make special statistical studies and compilations involving data from any returns, declarations, statements, or other documents required by this title or by regulations or from any records established or maintained in connection with the administration and enforcement of this title, to engage in any such special study or compilation jointly with the party or parties requesting it, and to furnish transcripts of any such special study or compilation, upon the payment, by the party or parties making the request, of the cost of the work or services performed for such party or parties.

SEC. 7516. SUPPLYING TRAINING AND TRAINING AIDS ON REQUESTS.

The Secretary or his delegate is authorized within his discretion, upon written request, to admit employees and officials of any State, the Commonwealth of Puerto Rico, any possession of the United States, any political subdivision or instrumentality of any of the foregoing, the District of Columbia, or any foreign government to training courses conducted by the Internal Revenue Service, and to supply them with texts and other training aids. The Secretary or his delegate may require payment from the party or parties making the request of a reasonable fee not to exceed the cost of the training and training aids supplied pursuant to such request.

(2) The table of sections for chapter 77 is amended by adding at the end thereof the following new items:

Sec. 7515. Special statistical studies and compilations and other services on request.
Sec. 7516. Supplying training and training aids on request.

(b) Section 7809 of the Internal Revenue Code of 1954 (relating to deposit of collections) is amended—

(1) by striking out "subsection (b)," in subsection (a) and inserting in lieu thereof "subsections (b) and (c) and in", and

(2) by adding at the end thereof the following new subsection:

(c) DEPOSIT OF CERTAIN RECEIPTS.—Moneys received in payment for—

(1) Work or services performed pursuant to section 7515 (relating to special statistical studies and compilations and other services on request);

(2) work or services performed (including materials supplied) pursuant to section 7516 (relating to the supplying of training and training aids on request); and

(3) other work or services performed for a State or a department or agency of the Federal Government (subject to all provisions of law and regulations governing disclosure of information) in supplying copies of, or data from, returns, statements, or other documents filed under authority of this title or records maintained in connection with the administration and enforcement of this title,

shall be deposited in a separate account which may be used to reimburse appropriations which bore all or part of the costs of such work or services, or to refund excess sums when necessary.

SEC. 4. Section 6512(b)(2) of the Internal Revenue Code of 1954 (relating to limit on amount of credit or refund of overpayment determined by the Tax Court) is amended by striking out "or" at the end of subparagraph (A); by striking out the period at the end of subparagraph (B) and inserting in lieu thereof ", or"; and by adding after subparagraph (B) the following new subparagraph:

(C) within the period which would be applicable under section 6511 (b)(2), (c), or (d), in respect of any claim for refund filed within the applicable period specified in section 6511 and before the date of the mailing of the notice of deficiency—

(i) which had not been disallowed before that date.

(ii) which had been disallowed before that date and in respect of which a timely suit for refund could have been commenced as of that date, or

(iii) in respect of which a suit for refund had been commenced before that date and within the period specified in section 6532.

SEC. 5. (a) Section 7701(a) of the Internal Revenue Code of 1954 is amended by adding after paragraph (31) the following new paragraph:

(32) COOPERATIVE BANK.—The term "cooperative bank" means an institution without capital stock organized and operated for mutual purposes and without profit, which—

(A) either—

(i) is an insured institution within the meaning of section 401(a) of the National Housing Act (12 U.S.C., sec. 1724(a)), or

(ii) is subject by law to supervision and examination by State or Federal authority having supervision over such institutions, and

(B) meets the requirements of subparagraphs (B), (C), (D), (E), and (F) of paragraph (19) of this subsection (relating to definition of domestic building and loan association) determined with the application of the second, third, and fourth sentences of paragraph (19).

In determining whether an institution meets the requirements referred to in subparagraph (B) of this paragraph, any reference to an association or to a domestic building and loan association contained in paragraph (19) shall be deemed to be a reference to such institution. In the case of an institution which, for the taxable year, is a cooperative bank within the meaning of the first sentence of this paragraph by reason of the application of the second and third sentences of paragraph (19) of this subsection, the deduction otherwise allowable under section 166(c) for a reasonable addition to the reserve for bad debts shall, under regulations prescribed by the Secretary or his delegate, be reduced in a manner consistent with the reductions provided by the table contained in section 593(b)(5).

(b) The amendment made by subsection (a) of this section shall apply with respect to taxable years beginning after the date of the enactment of the Revenue Act of 1962.

Approved October 23, 1962.

PUBLIC LAW 87-876
EIGHTY-SEVENTH CONGRESS, OCTOBER 24, 1962
H.R. 6371 [24]

An Act to amend the Internal Revenue Code of 1954 with respect to the limitation on retirement income, and with respect to the taxable year for which the deduction for interest paid will be allowable to certain building and loan associations, mutual savings banks, and cooperative banks.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 37(d) of the Internal Revenue Code of 1954 (relating to limitation on retirement income) is amended to read as follows:

(d) LIMITATION ON RETIREMENT INCOME.—For purposes of subsection (a), the amount of retirement income shall not exceed $1,524 less—

(1) in the case of any individual, any amount received by the individual as a pension or annuity—

(A) under title II of the Social Security Act,

(B) under the Railroad Retirement Acts of 1935 or 1937, or

(C) otherwise excluded from gross income, and

(2) in the case of any individual who has not attained age 72 before the close of the taxable year—

(A) if such individual has not attained age 62 before the close of the taxable year, any amount of earned income (as defined in subsection (g)) in excess of $900 received by such individual in the taxable year, or

(B) if such individual has attained age 62 before the close of the taxable year, the sum of (i) one-half the amount of earned income received by such individual in the taxable year in excess of $1,200 but not in excess of $1,700, and (ii) the amount of earned income so received in excess of $1,700.

SEC. 2. The amendment made by the first section of this Act shall apply only to taxable years ending after the date of the enactment of this Act.

SEC. 3. (a) Section 461 of the Internal Revenue Code of 1954 (relating to general rule for taxable year of deduction) is amended by adding at the end thereof the following new subsection:[25]

(e) DIVIDENDS OR INTEREST PAID ON CERTAIN DEPOSITS OR WITHDRAWABLE ACCOUNTS.—Except as provided in regulations prescribed by the Secretary or his delegate, amounts paid to, or credited to the accounts of, depositors or holders of accounts as dividends or interest on their deposits or withdrawable accounts (if such amounts paid or credited are withdrawable on demand subject only to customary notice to withdraw) by a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank shall not be allowed as a deduction for the taxable year to the extent such amounts are paid or credited for periods representing more than 12 months. Any such amount not allowed as a deduction as the result of the application of the preceding sentence shall be allowed as a deduction for such other taxable year as the Secretary or his delegate determines to be consistent with the preceding sentence.

(b) The amendment made by subsection (a) shall apply only with respect to taxable years ending after December 31, 1962.

Approved October 24, 1962.

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[24] Senate Report No. 2202, page 1237, this Bulletin; since House Report No. 992 is substantially the same as the Senate Report, it is not published herein.

[25] Sec. 3 introduced as H.R. 13358; related House Report No. 2544, page 1235, this Bulletin.

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PART III

COMMITTEE AND CONFERENCE REPORTS

[H.R. 11879] [1]

TAX RATE EXTENSION ACT OF 1962

[House Report No. 1738, Eighty-seventh Congress, Second Session]

[May 26, 1962]

Mr. MILLS, from the Committee on Ways and Means, submitted the following report to accompany H.R. 11879.

The Committee on Ways and Means, to whom was referred the bill (H.R. 11879) to provide a 1-year extension of the existing corporate normal-tax rate and of certain excise-tax rates, and for other purposes, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

I. SUMMARY OF BILL

H.R. 11879 continues the present corporate tax rate and certain existing excise tax rates for 1 year. In addition, it continues for 6 months, or until December 31, 1962, the present 10 percent tax with respect to the transportation of persons. At that time, the bill provides for the expiration of the excise tax on all forms of transportation of persons except transportation of persons by air. The tax on the transportation of persons by air is continued for an additional 6 months, or until July 1, 1963, but at a 5 percent rather than a 10 percent rate.

The existing tax rates which this bill continues for 1 year, or until July 1, 1963, are the present 52 percent corporate income tax rate, which would otherwise revert to 47 percent (the 5 percentage point reduction would occur in the 30 percent normal tax) and the present rates of excise tax on distilled spirits, beer, wine, cigarettes, passenger cars, automobile parts and accessories, and general telephone service. All of the taxes affected by this bill, except those relating to general telephone service and transportation of persons, are taxes which were increased at the time of the Korean war. The Tax Rate Extension Act of 1959 added the latter two taxes to the list of taxes subject to automatic reduction.

If this bill were not enacted, it is estimated that there would be a revenue loss of from $4.0 to $4.3 billion in a full year of operation and a loss of revenue in the fiscal year 1963 of from $2.7 to $2.9 billion (taking into account the effect of the bill on tax refunds).

The rate extensions contained in this bill generally conform with the President's recommendations.

II. EXPLANATION OF BILL

This bill provides for a 1-year extension of the present corporate income tax rates and the existing rates of certain excise taxes. The rates of these taxes which are extended for 1 year are, under existing law, scheduled for reduction on July 1, 1962. The present combined 52 percent corporate tax rate, without the 1-year extension provided by this bill, would revert to 47 percent as of July 1, 1962, through a reduction of the normal tax rate from 30 percent to 25 percent.

The excise tax rates which without this bill would be decreased as of July 1, 1962, are those on—

[1] Public Law 87–508, page 58, this Bulletin.

1. Distilled spirits, which would be reduced from $10.50 to $9 per proof gallon;
2. Beer, which would be reduced from $9 to $8 per barrel;
3. Wines, which are subject to various tax rates which would be reduced by approximately 11 percent;
4. Cigarettes, which would be reduced from 8 cents to 7 cents a pack;
5. Passenger cars, which would be reduced from 10 percent to 7 percent of the manufacturers' price;
6. Auto parts and accessories, which would be reduced from 8 percent to 5 percent of the manufacturers' price; and
7. General telephone service, which would be reduced from 10 percent of the amount paid to zero.

The corporate income tax rate and the tax rates referred to in the first six categories listed above reflect rate increases which were initially provided in 1951 at the time of the Korean war. Elimination of the tax on general telephone service (or local telephone service, as it formerly was called) and the reduction in the rate of tax on transportation of persons (referred to below) were first scheduled for the year 1960 in the Tax Rate Extension Act of 1959.

The bill, in addition to making the changes referred to above, also makes a number of technical changes, including the postponement for 1 more year of the floor stocks refunds or credits presently effective with respect to stocks of various tax-paid products on hand on July 1, 1962. These floor stocks refunds are available in the case of distilled spirits, wines and beer, cigarettes, and passenger cars.

In addition to the 1-year extensions in excise tax rates, referred to above, the bill also extends for 6 months, or until December 31, 1962, the present 10 percent tax on the transportation of persons. At that time the excise tax on transportation of persons by railroad, bus, water, or other form of transportation, except transportation of persons by air, is terminated. The tax on the transportation of persons by air is continued for an additional 6 months, until July 1, 1963, but at a rate of 5 percent rather than 10 percent.

Table 1 shows the present tax rates which are extended and those which would become effective as of July 1, 1962, in the absence of this bill.

TABLE 1.—*Tax rates affected by bill*

	Unit of tax	Present rates extended under the bill	Rates which under present law would be effective July 1, 1962
Corporations	Normal tax net income	30 percent	25 percent.
Excises:			
Liquor taxes:			
Distilled spirits	Per proof gallon	$10.50	$9.
Beer	Per barrel	$9	$8.
Wine:			
Containing less than 14 percent alcohol.	Per wine gallon	17 cents	15 cents.
Containing 14 to 21 percent alcohol.	do	67 cents	60 cents.
Containing 21 to 24 percent alcohol.	do	$2.25	$2.
Containing more than 24 percent alcohol.	do	$10.50	$9.
Sparkling wines, liqueurs, etc.:			
Champagne or sparkling wine	do	$3.40	$3.
Liqueurs, cordials, etc	do	$1.92	$1.60.
Artificially carbonated wine	do	$2.40	$2.
Tobacco taxes: Cigarettes	Per 1,000	$4	$3.50.
Manufacturers excise taxes:			
Passenger cars	Manufacturers' sale price	10 percent	7 percent.
Auto parts and accessories	do	8 percent	5 percent.
Miscellaneous taxes:			
General telephone	Amount charged	10 percent	0.
Transportation of persons	Amount paid	10 percent	5 percent.
By airline	do	10 percent [1]	5 percent.
By other carriers	do	10 percent [1]	5 percent.

[1] Rate of 10 percent extended through Dec. 31, 1962. Effective Jan. 1, 1963, tax on transportation by air to be 5 percent through June 30, 1963, and transportation by other carriers to be exempt.

The scheduled reduction of the tax on the transportation of persons by air, and elimination of the tax on the transportation of persons by other methods, are effective with respect to "transportation which begins after December 31, 1962." The scheduled elimination of the tax on the transportation of persons by air is effective with respect to transportation which begins after June 30, 1963. It is contemplated that the Internal Revenue Service, under regulations appropriately safeguarding the collection of taxes, will provide that the tax collected on tickets purchased *before* a date of rate change for travel beginning *on or after* that date may be the tax (zero or 5 percent, as the case may be) which will actually be due for this travel. For cases of this kind where the higher rate of tax is paid but not actually due, the bill makes provision for credit or refund. It provides that where excess tax with respect to transportation has been collected before a date of rate change (January 1 or July 1, 1963) for travel beginning on or after that date, the person who collected the tax (usually the carrier) is to be allowed a credit or refund for the excess tax collected if, before the transportation began, the collector of the tax repaid the excess tax to the person from whom he collected it or had obtained the consent of that person to the allowance of the credit or refund.

It is expected that with respect to transportation beginning after December 31, 1962, where a ticket is issued for transportation consisting in part of transportation by air and in part of other transportation, the Treasury by regulation or ruling will specify proper allocation rules to determine the portion of such ticket subject to tax.

The bill rewrites subchapter C of chapter 33, presently dealing with the transportation of persons, to make it applicable only to transportation of persons by air as of January 1, 1963. The changes made in this subchapter, however, are only those necessary to delete language relating to transportation of persons other than by air and to continue the rules presently applicable in the case of air travel.

The section of the code which contains the definition of "taxable transportation" (sec. 4262) remains the same as under present law. The same rules for determining taxable transportation will apply except that these rules will have application only in connection with the 5 percent tax on transportation of persons by air. It is intended that this section will be applicable to transportation of persons by air to the same extent as under the present law and regulations.

III. REVENUE EFFECT OF BILL

Tables 2 and 3 show the revenue effect of the tax rates extended by this bill as well as the effect of terminating as of the end of this year the tax on the transportation of persons other than by air and reducing the tax on the transportation of persons by air at that time to 5 percent. Table 2 contains the estimates of the staff of the Joint Committee on Internal Revenue Taxation and table 3 the estimates of the Treasury Department. These tables show total receipts anticipated from the taxes affected by this bill in the fiscal year 1963 and the effect of the changes made by this bill with respect to the fiscal year 1963. In addition, the tables also show the effect of the bill in a full year of operation. The full year effect of the bill will be to maintain receipts of $4 to $4.3 billion which would otherwise be lost. In the fiscal year 1963 the receipts maintained by the rate extensions and treatment of the tax on the transportation of persons will amount to $2.7 to $2.9 billion (taking into account the effect floor stock refunds otherwise would have).

TABLE 2.—*Estimates by the staff of the Joint Committee on Internal Revenue Taxation of the revenue effect of H.R. 11879 for the fiscal year 1963 and for a full year of operation*

[In millions of dollars]

	Receipts in fiscal 1963		Fiscal 1963 revenue gain under the bill	Full year effect of the bill
	Under the bill	Under present law, i.e., assuming scheduled reductions go into effect		
Corporation income tax	24,600	23,450	1,150	2,500
Excises:				
Liquor taxes:				
Distilled spirits	2,500	2,334	166	169
Beer	820	731	89	91
Wine	100	89	11	11
Total liquor	3,420	3,154	266	271
Tobacco taxes: Cigarettes	2,075	1,821	254	259
Total tobacco	2,075	1,821	254	259
Manufacturers' taxes:				
Passenger cars	1,400	1,033	367	420
Auto parts and accessories	200	134	66	75
Total manufacturers'	1,600	1,167	433	495
Miscellaneous taxes:				
General telephone	525	131	394	525
Transportation of persons:				
By airlines	[1] 169	117	52	[2] 0
By other carriers	[1] 74	66	8	[2] —58
Total miscellaneous	768	314	454	467
Total excise collections	7,863	6,456	1,407	1,492
Deduct floor stock refunds		188	—188	
Net excise taxes	7,863	6,268	1,595	1,492
Net revenues	32,463	29,718	2,745	3,992

[1] If the present 10 percent rate were in effect in fiscal 1963, the estimated yield of this tax would be $208,000,000 for airline travel and $117,000,000 for travel by other carriers.

[2] Assuming the full year at 5 percent rate for travel by airlines and no tax on travel by other carriers.

TABLE 3.—*Estimates by the Treasury Department of the revenue effect of H.R. 11879 for the fiscal year 1963 and for a full year of operation*

[In millions of dollars]

	Receipts in fiscal 1963		Fiscal 1963 revenue gain under the bill	Full year effect of the bill
	Under the bill	Under present law, i.e., assuming scheduled reductions go into effect		
Corporation income tax	27,400	26,100	1,300	2,800
Excise taxes:				
Alcohol:				
Distilled spirits	2,470	2,293	177	180
Beer	800	723	77	78
Wines	100	91	9	9
Total alcohol taxes	3,370	3,107	263	267
Tobacco: Cigarettes (small)	2,050	1,815	235	240
Manufacturers' excise taxes:				
Passenger automobiles	1,500	1,140	360	430
Parts and accessories for automobiles	200	140	60	73
Total manufacturers' excise taxes	1,700	1,280	420	503
Miscellaneous excise taxes; General telephone service	525	130	395	525
Transportation of persons:				
Air	177	125	52	
Other	63	54	9	−46
Total transportation of persons	240	179	61	[1] −46
Total miscellaneous excise taxes	765	309	456	479
Deduct: Refunds of receipts		226	−226	
Total excise taxes	7,885	6,285	1,600	1,489
Grand total	35,285	32,385	2,900	4,289

[1] The loss under the bill as compared to revenues from the present tax rate of 10 percent would be $193,000,000; $103,000,000 on transportation by air, and $90,000,000 from other transportation.

The difference between the estimates of the full year effect and the effect in the fiscal year 1963 are primarily attributable to the postponing of the corporate rate reduction, which is not fully reflected in receipts in the fiscal year 1963. There is also some lag in the collections in the manufacturers' excise taxes on passenger cars and auto parts and accessories, as well as in the case of the general telephone tax. In the case of the tax on the transportation of persons by air, the full year effect of the bill is the same as present law because the latter already provides for a 5 percent rate after June 30 of this year. In the case of other carriers, there is a revenue loss of $46 to $58 million on a full year's basis because of the elimination of the tax in this case rather than its continuation at 5 percent.

As shown in tables 2 and 3, $2.5 to $2.8 billion of the full year revenue loss of $4.0 to $4.3 billion prevented by this bill is attributable to the corporate income tax. Of the remainder, $267 to $271 million is attributable to the taxes on alcoholic beverages, $240 to $259 million to the taxes on cigarettes, $495 to $503 million to the automotive taxes, and $525 million to the general telephone tax. As noted above, there also is the revenue loss of $46 to $58 million in the case of the tax on the transportation of persons.

IV. EFFECT OF THE BILL ON THE BUDGET

The Director of the Bureau of the Budget in his appearance before your committee in executive session stated that at the present time it appears that the fiscal year 1962 will end with a budget deficit of approximately $7 billion, the same as the estimate in the budget in January. He indicated that both receipts

and expenditures, however, probably will be about $1 billion below the estimates in the budget. On the receipts side, the decline is primarily attributable to a drop below the level expected in the case of collections from corporate income taxes. On the expenditure side he stated that lower farm price supports outlays by the Commodity Credit Corporation are the largest single factor in the reduction now anticipated although there are several smaller decreases and a few increases.

The budget receipt and expenditure estimates for the fiscal year 1963 appearing in the January budget are as follows:

	Billion
Budget receipts	$93.0
Budget expenditures	92.5
Budget surplus	+0.5

The Director of the Bureau of the Budget did not present any basic revision of these figures. He stated:

> * * * The President has recommended certain amendments to the budget he submitted in January, but these in total would not lift the 1963 expenditure estimate to the point where expenditures would exceed the revenues as projected in January.

He also stated:

> * * * While the situation is subject to change, day by day, there is no clear indication at present of a need to make substantial revisions from the total of budget expenditures estimated in January."

With respect to the revenue outlook Director Bell stated:

> * * * The economic recovery continued to move ahead during the first quarter of this calendar year, although not quite as rapidly as our January estimates had anticipated. During the last few weeks, however, the pace of economic activity has been picking up and the outlook for steady advance is now brighter than it was a few weeks ago. In an economy as large and diverse as ours, substantial changes can occur quickly, and we do not believe we have enough evidence to date to provide a basis now for a specific revision of the January revenue estimates."

The staff of the Joint Committee on Internal Revenue Taxation also has prepared estimates of receipts for the fiscal year 1963. These estimates, assuming the same budget expenditures as shown in the budget, would indicate a deficit in the fiscal year 1963 of $3.8 billion if no account is taken of the revenue revision bill of 1962 (H.R. 10650). The staff estimated that if this bill were taken into account as it passed the House, the deficit for the fiscal year 1963 might amount to $4.9 billion. The staff estimates can be summarized as follows:

	Billion
Staff estimate of budget receipts (assuming extension of present corporate and excise tax rates) excluding revenue effect of pending bill, H.R. 10650	$88.7
Budget expenditures (as shown in the budget)	92.5
Deficit (excluding revenue effect of H.R. 10650)	3.8
Staff estimates of receipts including revenue effect of H.R. 10650	87.6
Budget expenditures (as shown in the budget)	92.5
Deficit (includes revenue effect of H.R. 10650)	4.9

NOTE.—Estimates released on Apr. 2, 1962.

V. REASONS FOR THE BILL

Your committee believes that the status of the budget as outlined above represents an impelling reason for the continuation of the present corporate and excise tax rates. The President in his budget message this last January stated:

> The budget outlook for 1963 requires that the present tax rates on corporation income and certain excises be extended for another year beyond their scheduled expiration date of June 30, 1962. Existing law calls for changes which would lower the general corporation income tax rate from 52 percent to 47 percent; reduce the excise rates on distilled spirits, beers, wines, cigarettes, passenger automobiles, and automobile parts and accessories; and allow the tax on general telephone service to expire.

> I recommend postponement of these changes for another year to prevent a revenue loss of $2.8 billion in 1963.

Under Secretary of the Treasury Fowler, in his appearance before your committee, stated:

> The estimated revenue loss of $2.8 billion for fiscal 1963 is so large that a failure to postpone the scheduled reductions would result in a substantial shift of the budget position from a proposed modest surplus to a substantial deficit.

Your committee believes that even if a tax reduction could appropriately be made at this time, it is not clear that the reductions which would occur in the absence of the extension of the specified corporate and excise tax rates would be the most desirable reductions.

With respect to the tax on the transportation of persons, the President recommended the repeal of this tax as of July 1 of this year except in the case of the tax on the transportation of persons by air. In the case of the tax on the transportation of persons by air, he recommended the continuation of the 10 percent rate until December 31, 1962, and a 5 percent rate thereafter. The President made this recommendation as one feature of a program of user charges. The action taken by your committee with respect to this tax on the transportation of persons by air is in accord with the proposal of the President except that the present 10 percent tax on all transportation of persons is continued for 6 more months, or until December 31, 1962. Your committee's bill does not take up other user charge proposals of the President.

As Under Secretary Fowler pointed out to your committee, the removal of the transportation tax in the case of the railroad industry is appropriate because the railroad industry operates with a minimum of Federal aid and is subject to State, local, and Federal taxes on its roadbed, equipment, and profits. However, as was pointed out, in the case of airlines there are "significant Federal capital and operating expenditures." Federal expenditures for the domestic airway system (operation plus depreciation of capital items) are approximately $500 million a year and growing. He also pointed out that the domestic air transport industry flew over 30 billion passenger miles in 1961 and had receipts of over $2 billion. As he indicated, this industry now generates over 50 percent more intercity passenger miles than the railroads and accounts for more than 40 percent of the common carrier intercity passenger miles.

VI. MINORITY VIEWS OF MESSRS. UTT AND ALGER

The Federal budget was last balanced in fiscal year 1960. At that time budgetary expenditures amounted to $76.5 billion. The spending projections for fiscal year 1963 as set forth in the budget message total $92.5 billion—a 21-percent increase over the 1960 level. The $16 billion proposed increase in spending is allocated 44 percent for defense purposes and 56 percent for nondefense purposes. These data become even more alarming when it is considered that the budget figures for fiscal year 1963 do not include some items that have been the subject of subsequent Presidential messages, such as the proposal to authorize the expenditure of $2.6 billion for an emergency public works program.

The undersigned have opposed the enactment of H.R. 11879 creating $4.3 billion in increased tax burdens because we are unwilling to ask the American people to pick up the tab for the unnecessary compulsive spending to which this administration and its down-the-line supporters in Congress and elsewhere seem dedicated. Conditions in our economy tend to softness, imply uncertainty, and suggest a lack of confidence in current Government policies affecting our free enterprise system. We believe that now is the time for less taxes instead of more taxes; we believe now is the time for less Government spending so that we can as a nation live within our means.

In the past 31 years the Federal budget has been unbalanced 25 times and balanced only 6 times. Thus, in the past three decades we have failed to pay our way 80 percent of the time. There is no present indication that this deficit course of national profligacy will change in the foreseeable future unless the Congress, with the strong backing of the American people, once more resumes its constitutional obligation of controlling our fiscal and budgetary affairs. The deficit for the current fiscal year will approach $10 billion and the estimated deficit for next year has been placed as high as $5 billion.

This type of fiscal mismanagement, if allowed to continue, threatens our very survival. It is not a lack of increased tax revenue that has caused this suc-

cession of deficits. Indeed, projected revenues for fiscal year 1963 suggest that receipts in the forthcoming fiscal year will be somewhat more than $10 billion higher than receipts in fiscal year 1960 when we last had a budgetary balance. It is apparent, therefore, that the real cause of our current problems is too much spending and not too little taxation.

It is imperative that we spend less so we can tax less. The undersigned have consistently supported well-considered endeavors to bring about an easily attainable reduction in our spending commitments. Even administration spokesmen periodically refer to the need for increased incentive through tax reduction. We believe the incentive is needed now. We believe that taxes should be lowered by permitting the "temporary wartime" taxes covered in this bill to expire and further that the tax reduction should be made more sweeping. These reductions would be made possible by lower spending.

We are opposed to H.R. 11879. We must face up to the urgent need for our free enterprise system to have lower tax burdens to increase job opportunities and to strengthen our productive capacities. We must have prudence in the conduct of our government affairs. We must abandon the fallacious notion that government spending can solve our every problem. The time is now urgently at hand to call a halt to the seemingly endless fiscal drift of budgetary deficits based on government extravagance. The American people should not be forced through compulsory taxation to finance the spenders.

James B. Utt.
Bruce Alger.

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[H.R. 11879] [2]

TAX RATE EXTENSION ACT OF 1962

[Senate Report No. 1616, Eighty-seventh Congress, Second Session, Calendar No. 1576]

[June 22, 1962]

Mr. Byrd of Virginia, from the Committee on Finance, submitted the following report to accompany H.R. 11879.

The Committee on Finance, to whom was referred the bill (H.R. 11879) to provide a 1-year extension of the existing corporate normal tax rate and of certain excise-tax rates, and for other purposes, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

I. SUMMARY

H.R. 11879, both as passed by the House and with your committee's amendments, continues the present corporate tax rate and certain existing excise tax rates for 1 year.

In addition, both the House bill and your committee's amendments reduce or eliminate the tax on the transportation of persons. Your committee's amendments provide for the expiration of the excise tax on all forms of transportation of persons, except transportation of persons by air, effective October 1, 1962, and in the case of transportation of persons by air for the reduction of the tax from 10 percent to 5 percent effective as of the same date. (The House bill would continue the present rate of 10 percent for all of these forms of transportation until December 31, 1962.)

In addition, your committee's amendments provide in the case of the tax on transportation of persons by air, where travel is either begun or ended outside the United States, that any travel from one location in the United States to another is not to be subject to tax if any scheduled stopover in the United States is not for more than 6 hours. One other amendment made by your committee relates to the taxes on communications. This amendment exempts from the 10-percent general telephone tax or the 10-percent wire mileage tax private lines or leased wires which permit communication from one fixed location to another, but only when they are used in a trade or business. This exempts from tax service charges for community television antennas, private line telephones or teletypewriters and similar services used in a business.

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[2] Public Law 87–508, page 58, this Bulletin.

The existing tax rates which under both the House bill and your committee's amendments are continued for 1 year, or until July 1, 1963, are the present 52-percent corporate income tax rate, which would otherwise revert to 47 percent (the 5-percentage-point reduction would occur in the 30-percent normal tax) and the present rates of excise tax on distilled spirits, beer, wine, cigarettes, passenger cars, automobile parts and accessories, and general telephone service. All of the taxes affected by this bill, except those relating to general telephone service and transportation of persons, are taxes which were increased at the time of the Korean war. The Tax Rate Extension Act of 1959 added the latter two taxes to the list of taxes subject to automatic reduction.

If this bill were not enacted, it is estimated that there would be a revenue loss of about $4 billion in a full year of operation and a loss of revenue in the fiscal year 1963 of about $2.7 billion (taking into account the effect of the bill on tax refunds).

II. REVENUE EFFECT OF BILL

Table 1 shows the revenue effect of the tax rates extended by this bill as well as the effect of the House bill and your committee's amendments with respect to the tax on transportation of persons. This table shows total receipts anticipated from the taxes affected by this bill in the fiscal year 1963 and the effect of the changes made by the House and your committee's versions of this bill with respect to the fiscal year 1963. In addition, the table also shows the effect of both versions of the bill in a full year of operation.

TABLE 1.—*Estimates of the revenue effect of H.R. 11879 for the fiscal year 1963 and for a full year of operation*

[Millions of dollars]

	Receipts in fiscal 1963			Revenue gain, fiscal 1963		Full-year effect	
	Under present law, i.e., assuming scheduled reductions go into effect	Under House bill	Under your committee's bill	Under House bill	Under your committee's bill	Under House bill	Under your committee's bill
Corporation income tax	23,450	24,600	24,600	1,150	1,150	2,500	2,500
Excises:							
Liquor taxes:							
Distilled spirits	2,334	2,500	2,500	166	166	169	169
Beer	731	820	820	89	89	91	91
Wine	89	100	100	11	11	11	11
Total liquor	3,154	3,420	3,420	266	266	271	271
Tobacco taxes: Cigarettes	1,821	2,075	2,075	254	254	259	259
Total tobacco	1,821	2,075	2,075	254	254	259	259
Manufacturers' taxes:							
Passenger cars	1,033	1,400	1,400	367	367	420	420
Auto parts and accessories	134	200	200	66	66	75	75
Total manufacturers'	1,167	1,600	1,600	433	433	495	495
Miscellaneous taxes:							
General telephone	131	525	[1] 511	394	380	525	[1] 507
Transportation of persons:							
By airlines	117	169	140	52	23	[2] 0	[1] [2] −4
By other carriers	66	74	45	8	−21	[2] −58	[2] −58
Total miscellaneous	314	768	696	454	382	467	445
Total excise tax collections	6,456	7,863	7,791	1,407	1,335	1,492	1,470
Deduct floor stock refunds	188			−188	−188		
Net excise taxes	6,268	7,863	7,791	1,595	1,523	1,492	1,470
Net revenues	29,718	32,463	32,391	2,745	2,673	3,992	3,970

[1] Adjusted for committee amendments providing exemptions.
[2] Assuming the full year at 5-percent rate for travel by airlines and no tax on travel by other carriers.

Source: Staff of the Joint Committee on Internal Revenue Taxation.

The full-year effect of the House bill is to maintain receipts of $3,992 million which would otherwise be lost. Your committee's amendments result in a reduction on a full-year basis of $22 million, $18 million attributable to the modifications made in the base of the tax on communications and $4 million to the modification made in the base of the tax on transportation of persons by air. In the fiscal year 1963 the receipts maintained under the House bill amount to $2,745 million and under your committee's amendments $2,673 million, a decrease of $72 million.

As shown in table 1, $2.5 billion of the full-year revenue gain of about $4 billion provided by this bill is attributable to the corporate income tax. Of the remainder, $271 million is attributable to the taxes on alcoholic beverages, $259 million to the taxes on cigarettes, $495 million to the automotive taxes, and $507 million ($525 million under the House bill) to the general telephone tax. There is the revenue loss of $62 million in the case of the tax on the transportation of persons.

The difference between the estimates of the full-year effect and the effect in the fiscal year 1963 is primarily attributable to the postponement of the corporate rate reduction, which is not fully reflected in receipts in the fiscal year 1963. There is also some lag in the collections in the manufacturers' excise taxes on passenger cars and auto parts and accessories, as well as in the case of the general telephone tax.

In the case of the tax on the transportation of persons by air, the full-year effect of the bill (based on the 5-percent rate effective October 1, 1962) is slightly less than under present law because your committee amends this provision to exempt U.S. portions of certain international travel. In the case of other carriers, there is a revenue loss on a full year's basis because of the elimination of the tax on September 30, 1962 (or December 31, 1962, under the House bill), rather than a continuation of this rate at 5 percent.

III. REASONS FOR THE TAX RATE EXTENSIONS

The Secretary of the Treasury in his appearance before your committee indicated that the Treasury is now assuming a deficit of $7¼ billion in the fiscal year 1962 for purposes of making its computations.

The budget receipt and expenditure estimates for the fiscal year 1963 appearing in the January budget are as follows:

	Billion
Budget receipts	$93.0
Budget expenditures	92.5
Budget surplus	+0.5

The Secretary of the Treasury in commenting on the budgetary situation for the fiscal year 1963 stated:

> The estimate for the surplus of the next fiscal year as contained in the budget document was just under $500 million. Since then the President has sent up a number of additional requests, the largest one of which was the public works program for distressed areas, and those extra expenditures under those requests would just about balance out that small surplus. * * * I think that the budget, as submitted by the President, and as modified by the President since that time, is exactly, I would say, in balance.

The staff of the Joint Committee on Internal Revenue Taxation also has prepared estimates of receipts for the fiscal year 1963. These estimates, assuming the same budget expenditures as shown in the budget, would indicate a deficit in the fiscal year 1963 of $3.8 billion if no account is taken of the revenue revision bill of 1962 (H.R. 10650). The staff estimated that if this bill were taken into account as it passed the House, the deficit for the fiscal year 1963 might amount to $4.9 billion. The staff estimates can be summarized as follows:

	Billion
Staff estimate of budget receipts (assuming extension of present corporate and excise tax rates) excluding revenue effect of pending bill, H.R. 10650	$88.7
Budget expenditures (as shown in the budget)	92.5
Deficit (excluding revenue effect of H.R. 10650)	3.8
Staff estimates of receipts including revenue effect of H.R. 10650	87.6
Budget expenditures (as shown in the budget)	92.5
Deficit (includes revenue effect of H.R. 10650)	4.9

NOTE.—Estimates released on Apr. 2, 1962.

Your committee believes that the status of the budget as outlined above represents an impelling reason for the continuation of the present corporate and excise tax rates. The President in his budget message this last January stated:

> The budget outlook for 1963 requires that the present tax rates on corporation income and certain excises be extended for another year beyond their scheduled expiration date of June 30, 1962. Existing law calls for changes which would lower the general corporation income tax rate from 52 percent to 47 percent; reduce the excise rates on distilled spirits, beers, wines, cigarettes, passenger automobiles, and automobile parts and accessories; and allow the tax on general telephone service to expire. I recommend postponement of these changes for another year to prevent a revenue loss of $2.8 billion in 1963.

Secretary of the Treasury Dillon, in his appearance before your committee, stated:

> I feel that H.R. 11879 constitutes a necessary revenue conserving measure at this time, and I recommend its approval by your committee.

With respect to the tax on the transportation of persons, the President recommended the repeal of this tax as of July 1 of this year except in the case of the tax on the transportation of persons by air. In the case of the tax on the transportation of persons by air, he recommended the continuation of the 10-percent rate until December 31, 1962, and a 5-percent rate thereafter. The President made this recommendation as one feature of a program of user charges.

The House bill continued the 10-percent tax on all transportation of persons for 6 more months, or until December 31, 1962. Your committee's amendments, because of the pressing need for action with respect to the tax on the transportation of persons, continue the 10-percent tax only until October 1, 1962. At that time your committee's amendments provide for the elimination of the tax on transportation of persons other than by air and for the reduction from 10 percent to 5 percent of the tax on the transportation of persons by air. Neither the House bill nor your committee's amendments take up the other user charge proposals of the President.

The removal of the transportation tax in the case of the railroad industry is appropriate because the railroad industry operates with a minimum of Federal aid and is subject to State, local, and Federal taxes on its roadbed, equipment, and profits. In the case of airlines there are significant Federal capital and operating expenditures. Federal expenditures for the domestic airway system (operation plus depreciation of capital items) are approximately $500 million a year and growing. Moreover, the domestic air transport industry flew over 30 billion passenger miles in 1961 and had receipts of over $2 billion. This industry now generates over 50 percent more intercity passenger miles than the railroads, and accounts for more than 40 percent of the common carrier intercity passenger miles.

IV. COMMITTEE AMENDMENTS

Your committee has made three amendments to the House bill.

A. TERMINATION OF TAX ON TRANSPORTATION OF PERSONS OTHER THAN BY AIR

The first amendment, already referred to above, provides for the termination of all taxes on the transportation of persons, other than by air. and the reduction of the tax on the transportation of persons by air, as of September 30 of this year, rather than as of December 31, 1962, as provided by the House bill. As previously indicated, this amendment, except for the modifications as to the effective dates, is in accord with the President's recommendations. It is desirable to reduce the Federal taxes on railroads as soon as possible, because they are already paying heavy State and local property taxes on their railroad bed and equipment and because they are faced with substantial financial problems at the present time. At the same time your committee believes that it is undesirable to permit a differential in tax rates of more than 5 percent in the case of air carriers and other carriers. In view of these factors, your committee's amendments provide for the reduction of the tax applicable in the case of air carriers from 10 percent to 5 percent and the termination of the tax in the case of other carriers, all effective as of September 30, 1962.

B. U.S. PORTION OF INTERNATIONAL AIR TRAVEL

A second amendment made by your committee relates only to the tax on the transportation of persons by air. It exempts from the transportation tax the U.S. portion, or leg, of an interrupted international air trip. This exemption is desirable both because it removes a discrimination against American air carriers and also because it removes a discrimination against stopovers in the United States. Foreign air carriers make fewer stops in the United States than domestic carriers, with the result that a larger portion of an international trip provided by a foreign carrier is likely to be exempt than is true in the case of an international trip on an American airline. Flights from Chicago to Europe, for example, in the case of foreign carriers avoid any stops in the United States, while flights on an American airline generally provide for a stop in New York City. As a result, the trip, if provided by a foreign carrier, is entirely free of tax under present law, while the New York to Chicago leg of the trip in the case of the domestic carrier is taxed at 10 percent. Numerous similar situations arise in the case of flights from other American cities to foreign countries. In addition, in the case of American carriers, taxing the American leg of international air travel tends to encourage stopovers in Canada or other neighboring countries, rather than American border cities, since this avoids the imposition of tax on any American leg of the travel.

In view of the manner in which present law tends to discriminate against domestic carriers, and also to encourage foreign rather than American stops, your committee has amended this bill to provide that the U.S. portion of uninterrupted international air transportation is not to be subject to the 5-percent tax on transportation. The bill defines uninterrupted international air transportation as transportation which does not begin and end in the United States (or in the 225-mile zone along U.S. borders) if the "scheduled" interval between the beginning or end of the U.S. leg of such transportation and the end or beginning of the remainder of the transportation is not more than 6 hours. The amendment also provides that where there are two or more stops in the United States in the case of such a trip, neither of the stops, from the time of the beginning or end of one and the end or beginning of the other, may involve a "scheduled" interval of more than 6 hours. A "scheduled interval" of not more than 6 hours may include cases where the actual time elapsing exceeds 6 hours if the longer time it attributable to the postponement of a flight by the airline and was not attributable to the cancellation of a reservation by the passenger in order to take a later flight.

In connection with this same amendment, a change is also made in the provision dealing with the payment of the tax on the transportation of persons by air in cases where the tax is not paid at the time the transportation is purchased. Generally in such cases, it must be paid by the purchaser of the ticket to the Treasury Department or to the person to whom the payment for transportation is made. The bill, as amended, provides that in the case of international travel it may also be made to any person furnishing any part of the transportation. This and other administrative provisions make possible, if the Treasury by regulations so provides, the collection of tax, on the U.S. leg of what was originally scheduled as international transportation, from the carrier providing the foreign portion of the transportation, if subsequently the foreign portion of the flight is not taken and the passenger seeks a refund from this carrier for this portion of the travel. Similarly, the Treasury may by regulations provide for the collection of the tax from such a carrier with respect to the U.S. leg of such a trip if the scheduled interval, although initially not more than 6 hours, as the result of a change in reservations is lengthened beyond 6 hours. Provision could be made for the collection of the tax in such cases by requiring that the ticket for the foreign portion of the trip be marked as being associated with U.S. travel, the ticket for which has been purchased free of tax.

This amendment is effective with respect to transportation beginning after September 30, 1962.

C. EXEMPTION FROM COMMUNICATIONS TAXES

The third amendment added by your committee deals with the taxes on communications. The amendment made by your committee in the case of these taxes provides an exemption for amounts paid for certain private lines and leased wires.

The Federal Communications Commission in 1959 set aside certain radio frequencies for private microwave communications. In so doing the FCC provided users of communications with a choice of either supplying their own communication facilities or of obtaining such services from a communications common carrier. New developments in communications are now occurring with increasing frequency and the electrical and electronic manufacturing industries are already offering a wide variety of equipment directly to users to perform communication functions through the use of microwave channels.

Under present law, if the communications services are obtained from a common carrier, the 10-percent general telephone or wire mileage service taxes are applicable. However, where the equipment is purchased and the users then provide their own communications, no tax is applicable.

In addition, the Treasury Department has interpreted the 10-percent tax on wire mileage service as applying to certain amounts paid by community antenna television services. In such cases this community antenna service is privately operated by a company utilizing taxable microwave service furnished by a telephone company from the point of pickup to the booster station, which in turn transmits the signals by means of individual wires into the homes of the users of this service. Your committee believes that no communications tax should be applied to the company in such cases since to provide a tax in this case discriminates against television viewers who, because of distance from the TV station or as a result of the presence of mountains or valleys, cannot receive programs without the use of a special community antenna service.

To prevent discrimination against the communications common carriers and also to prevent the imposition of tax on community antenna service, your committee has added a new section to the bill providing that wire-mileage service is to include only service not used in the conduct of a trade or business (of the type referred to in sec. 162 of the code). It has also provided an exemption from the tax on general telephone service for amounts paid for the use of telephone or radio telephone lines or channels constituting general telephone service if such lines or channels are furnished between specified locations in different States or between specified locations in different counties, municipalities, or similar political subdivisions of a State and if such services are used in the conduct of a trade or business (of the type referred to in sec. 162 of the code).

This exemption from the general telephone tax removes from tax amounts paid for private lines and associated equipment used predominantly for voice purposes and over which communication may be established between specified and preselected points set aside for the exclusive use of customers, for whatever purpose he chooses, without the use of switching functions of a communications company exchange. The area limitations in this case are intended to exclude interior communication systems capable of being used through exchanges to communicate within the public exchange network. The term "similar subdivisions" of a State is intended to include subdivisions similar to a county or municipality which may be otherwise denominated in a particular State. In the case of more than one level of local government, the term "municipality" means the largest subdivsion below the level of county or similar subdivision.

Examples of the types of lines or channels and equipment furnished by the communications companies which if used in a trade or business would no longer be subject to tax are:

Private line telephone (if the conditions are met).
Private line teletypewriter.
Educational television channels.
Community antenna television channels.
Closed circuit television channels.
TELPAK.
Private line data transmission.

This amendment is made with respect to services furnished after June 30, 1962.

V. EXPLANATION OF CORPORATE INCOME AND EXCISE TAX RATE EXTENSIONS

Both versions of this bill provide for a 1-year extension of the present corporate income tax rates and the existing rates of certain excise taxes. The rates of these taxes which are extended for 1 year are, under existing law, scheduled for reduction on July 1, 1962. The present combined 52 percent corporate tax rate, without the 1-year extension, would revert to 47 percent as of July 1, 1962, through a reduction of the normal tax rate from 30 percent to 25 percent.

The excise tax rates extended by this bill which under present law would be decreased as of July 1, 1962, are those on—

1. Distilled spirits, which would be reduced from $10.50 to $9 per proof gallon;
2. Beer, which would be reduced from $9 to $8 per barrel;
3. Wines, which are subject to various tax rates which would be reduced by approximately 11 percent;
4. Cigarettes, which would be reduced from 8 cents to 7 cents a pack;
5. Passenger cars, which would be reduced from 10 percent to 7 percent of the manufacturers' price;
6. Auto parts and accessories, which would be reduced from 8 percent to 5 percent of the manufacturers' price; and
7. General telephone service, which would be reduced from 10 percent of the amount paid to zero.

The corporate income tax rate and the tax rates referred to in the first six categories listed above reflect rate increases which were initially provided in 1951 at the time of the Korean war. Elimination of the tax on general telephone service (or local telephone service, as it formerly was called) and the reduction in the rate of tax on transportation of persons (referred to below) were first scheduled for the year 1960 in the Tax Rate Extension Act of 1959.

Both versions of the bill, in addition to making the changes referred to above, also make a number of technical changes, including the postponement for 1 more year of the floor stocks refunds or credits presently effective with respect to stocks of various tax-paid products on hand on July 1, 1962. These floor stocks refunds are available in the case of distilled spirits, wines and beer, cigarettes, and passenger cars.

The bill as amended by your committee provides for the termination of the tax on the transportation of persons by railroad, motor vehicle, or water on September 30, 1962, and for the reduction of the tax on the transportation of persons by air to 5 percent on the same date. This air tax is then continued until July 1, 1963, but at this reduced rate of 5 percent.

Table 2 shows the present tax rates which are extended and those which would become effective as of July 1, 1962, in the absence of this bill.

The elimination of the tax on the transportation of persons other than by air, and the scheduled reduction of the tax on the transportation of persons by air

TABLE 2.—*Tax rates affected by the bill*

	Unit of tax	Rates under the bill	Rates which under present law would be effective July 1, 1962
Corporations	Normal tax net income	30 percent	25 percent.
Excises:			
Liquor taxes:			
Distilled spirits	Per proof gallon	$10. 50	$9.
Beer	Per barrel	$9	$8.
Wine:			
Containing less than 14 percent alcohol.	Per wine gallon	17 cents	15 cents.
Containing 14 to 21 percent alcohol.	do	67 cents	60 cents.
Containing 21 to 24 percent alcohol.	do	$2.25	$2.
Containing more than 24 percent alcohol.	do	$10.50	$9.
Sparkling wines, liqueurs, etc.:			
Champagne or sparkling wine	do	$3.40	$3.
Liqueurs, cordials, etc	do	$1.92	$1.60.
Artificially carbonated wine	do	$2.40	$2.
Tobacco taxes: Cigarettes	Per 1,000	$4	$3.50.
Manufacturers excise taxes:			
Passenger cars	Manufacturers' sale price	10 percent	7 percent.
Auto parts and accessories	do	8 percent	5 percent.
Miscellaneous taxes:			
General telephone	Amount charged	10 percent	0.
Transportation of persons:			
By airline	Amount paid	10 percent [1]	5 percent.
By other carriers	do	10 percent [1]	5 percent.

[1] Rate of 10 percent extended through Sept. 30, 1962. Effective Oct. 1, 1962, tax on transportation by air to be 5 percent through June 30, 1963, and transportation by other carriers to be exempt.

are effective with respect to "transportation which begins after" September 30, 1962. The scheduled elimination of the tax on the transportation of persons by air is effective with respect to transportation which begins after June 30, 1963. It is contemplated that the Internal Revenue Service, under regulations appropriately safeguarding the collection of taxes, will provide that the tax collected on tickets purchased *before* a date of rate change for travel beginning *on or after* that date may be the tax (zero or 5 percent, as the case may be) which will actually be due for this travel. For cases of this kind where the higher rate of tax is paid but not actually due, the bill makes provision for credit or refund. It provides that where excess tax with respect to transportation has been collected before a date of rate change (October 1, 1962, or July 1, 1963) for travel beginning on or after that date, the person who collected the tax (usually the carrier) is to be allowed a credit or refund for the excess tax collected if, before the transportation began, the collector of the tax repaid the excess tax to the person from whom he collected it or had obtained the consent of that person to the allowance of the credit or refund.

It is expected that with respect to transportation beginning after September 30, 1962, where a ticket is issued for transportation consisting in part of transportation by air and in part of other transportation, the Treasury by regulation or ruling will specify proper allocation rules to determine the portion of such ticket subject to tax.

The bill, as amended by your committee, rewrites subchapter C of chapter 33, presently dealing with the transportation of persons, to make it applicable only to transportation of persons by air as of October 1, 1962. The changes made in this subchapter, except for the committee amendment previously explained, however, are only those necessary to delete language relating to transportation of persons other than by air and to continue the rules presently applicable in the case of air travel.

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[H.R. 11879][5]

TAX RATE EXTENSION ACT OF 1962

[Conference Report No. 1935, Eighty-seventh Congress, Second Session]

[June 26, 1962]

Mr. MILLS, from the committee of conference, submitted the following Conference Report to accompany H.R. 11879.

The committee of conference on the disagreeing votes of the two Houses on the amendments of the Senate to the bill (H.R. 11879) to provide a 1-year extension of the existing corporate normal-tax rate and of certain excise-tax rates, and for other purposes, having met, after full and free conference, have agreed to recommend and do recommend to their respective Houses as follows:

That the House recede from its disagreement to the amendments of the Senate numbered 10, 11, and 12, and agree to the same.

Amendment numbered 1:

That the House recede from its disagreement to the amendment of the Senate numbered 1, and agree to the same with an amendment as follows:

On page 2, line 14, of the Senate engrossed amendments strike out "July 1, 1962" and insert *January 1, 1963;* and the Senate agree to the same.

Amendment numbered 2:

That the House recede from its disagreement to the amendment of the Senate numbered 2, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following:

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[5] Public Law 87–508, page 58, this Bulletin.

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SEC. 5. EXTENSION THROUGH NOVEMBER 15, 1962, OF TAX ON TRANSPORTATION OF PERSONS, AND FURTHER EXTENSION OF TAX ON TRANSPORTATION OF PERSONS BY AIR AT 5-PERCENT RATE FOR PERIOD NOVEMBER 16, 1962, THROUGH JUNE 30, 1963.

And the Senate agree to the same.

Amendment numbered 3:

That the House recede from its disagreement to the amendment of the Senate numbered 3, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *November 16, 1962;* and the Senate agree to the same.

Amendment numbered 4:

That the House recede from its disagreement to the amendment of the Senate numbered 3, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *November 16, 1962;* and the Senate agree to the same.

Amendment numbered 5:

That the House recede from its disagreement to the amendment of the Senate numbered 3, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *November 16, 1962;* and the Senate agree to the same.

Amendment numbered 6:

That the House recede from its disagreement to the amendment of the Senate numbered 6, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *November 15;* and the Senate agree to the same.

Amendment numbered 7:

That the House recede from its disagreement to the amendment of the Senate numbered 7, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *November 15;* and the Senate agree to the same.

Amendment numbered 8:

That the House recede from its disagreement to the amendment of the Senate numbered 8, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *November 15;* and the Senate agree to the same.

Amendment numbered 9:

That the House recede from disagreement to the amendment of the Senate numbered 9, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *November 15;* and theSenate agree to the same.

Amendment numbered 13:

That the House recede from its disagreement to the amendment of the Senate numbered 13, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *November 15;* and the Senate agree to the same.

Amendment numbered 14:

That the House recede from its disagreement to the amendment of the Senate numbered 14, and agree to the same with amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *November 16, 1962;* and the Senate agree to the same.

Amendment numbered 15:

That the House recede from its disagreement to the amendment of the Senate numbered 15, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *November 16, 1962;* and the Senate agree to the same.

Amendment numbered 16:

That the House recede from its disagreement to the amendment of the Senate numbered 16, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *November 16, 1962;* and the Senate agree to the same.

Amendment numbered 17:

That the House recede from its disagreement to the amendment of the Senate numbered 17, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *November 16, 1962;* and the Senate agree to the same.

Amendment numbered 18:

That the House recede from its disagreement to the amendment of the Senate numbered 18, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *November 15;* and the Senate agree to the same.

Amendment numbered 19:

That the House recede from its disagreement to the amendment of the Senate numbered 19, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *November 16, 1962;* and the Senate agree to the same.

W. D. Mills,
Cecil R. King,
Thomas J. O'Brien,
Noah Mason,
John W. Byrnes,
Managers on the Part of the House.

Harry F. Byrd,
Robt. Kerr,
Russell Long,
By Harry F. Byrd
John J. Williams,
Frank Carlson,
Managers on the Part of the Senate.

STATEMENT OF THE MANAGERS ON THE PART OF THE HOUSE

The managers on the part of the House at the conference on the disagreeing votes of the two Houses on the amendments of the Senate to the bill (H.R. 11879) to provide a 1-year extension of the existing corporate normal-tax rate and of certain excise-tax rates, and for other purposes, submit the following statement in explanation of the effect of the action agreed upon by the conferees and recommended in the accompanying conference report:

Amendment No. 1: This amendment adds a new section 4 to the bill to exempt from the communications tax certain private line services used in the conduct of a trade or business.

Under section 4252(e) of the Internal Revenue Code of 1954, wire mileage service is defined to mean any telephone or radiotelephone service, and any other wire or radio circuit service, not included in any other subsection of section 4252 of the code; except that such term does not include service used exclusively in furnishing wire and equipment service. Subsection (a) of the new section 4 amends section 4252(e) so that wire mileage service will include only service not used in the conduct of a trade or business.

Subsection (b) of the new section 4 added by Senate amendment No. 1 adds a new subsection (j) to section 4253 of the 1954 Code (relating to exemptions from the communications tax). Under the amendment the communications tax is not to be imposed on any amount paid for the use of any telephone or radiotelephone line or channel which constitutes general telephone service (within the meaning of sec. 4252(a) of the 1954 Code) if such use is in the conduct of a trade or business and such line or channel is furnished between specified locations in different States or between specified locations in different counties, municipalities, or similar political subdivisions of a State.

Subsection (c) of the new section 4 provides that the amendments made by subsections (a) and (b) are to apply with respect to services furnished on or after July 1, 1962.

The House recedes with an amendment which changes the effective date from July 1, 1962, to January 1, 1963.

Amendments Nos. 2, 3, 4, 5, 6, 7, 8, and 9: The bill as passed by the House provided for a 6-month extension of the existing tax on transportation of persons by rail, motor vehicle, water, or air at 10 percent for the period July 1, 1962, through December 31, 1962, and a further 6-month extension of the tax on transportation of persons by air at 5 percent for the period January 1, 1963, through June 30, 1963.

Senate amendments Nos. 2, 3, and 4 provide a 3-month extension of the existing 10-percent tax on transportation of persons for the period July 1, 1962, through September 30, 1962, and Senate amendments Nos. 5, 6, 7, 8, and 9 provide a further 9-month extension of the tax on transportation of persons by air at 5 percent for the period October 1, 1962, through June 30, 1963.

Under the conference agreement, the existing 10-percent tax on transportation of persons is extended through November 15, 1962, and the tax on transportation of persons by air is further extended at 5 percent for the period November 16, 1962, through June 30, 1963.

Amendments Nos. 10 and 11: Section 4262(a) of the 1954 Code defines taxable transportation as meaning—

(1) transportation which begins in the United States or in the 225-mile zone and ends in the United States or in the 225-mile zone, and

(2) in the case of transportation other than transportation described in paragraph (1), that portion of such transportation which is directly or indirectly from one port or station in the United States to another port or station in the United States.

The bill as passed by the House did not change such section 4262(a).

Senate amendment No. 10 amends paragraph (2) of such section 4262(a) to provide that the portion of the transportation referred to in paragraph (2) is to be included as taxable transportation only if such portion is not a part of uninterrupted international air transportation. Senate amendment No. 11 adds a new paragraph (3) to section 4262(c) of the 1954 Code to define the term "uninterrupted international air transportation". The term is defined to mean any transportation by air which is not transportation described in section 4262(a)(1) of the 1954 Code and in which—

(A) the scheduled interval between (i) the beginning or end of the portion of such transportation which is directly or indirectly from one port or station in the United States to another port or station in the United States and (ii) the end or beginning of the other portion of such transportation is not more than 6 hours, and

(B) the scheduled interval between the beginning or end and the end or beginning of any two segments of the portion of such transportation referred to in clause (i) above is not more than 6 hours.

The House recedes on Senate amendments Nos. 10 and 11.

Amendment No. 12: Section 4264(c) of the 1954 Code provides that where the tax on transportation of persons is not paid at the time payment for transportation is made then (under regulations prescribed by the Secretary of the Treasury or his delegate, to that extent that such tax is not collected under any other provision of subchapter C of chapter 33 of the code, payment of the tax is to be made to the person to whom the payment for transportation was made or to the Secretary of the Treasury or his delegate. In connection with Senate amendments Nos. 10 and 11, Senate amendment No. 12 provides that payment of such tax shall be made to the Secretary of the Treasury or his delegate, to the person to whom the payment for transportation was made, or, in the case of transportation other than transportation described in section 4262(a)(1) of the code, to any person furnishing any portion of such transportation.

The House recedes.

Amendments Nos. 13, 14, 15, 16, 17, 18, and 19: These are conforming amendments relating to the effective dates for changes in the tax on the transportation of persons.

The House recedes with conforming amendments.

W. D. Mills,
Cecil R. King,
Thomas J. O'Brien,
Noah Mason,
John W. Byrnes,
Managers on the Part of the House.

[H.R. 1261][4]

EXTENSION OF RENEGOTIATION ACT OF 1951

[Senate Report No. 1669, Eighty-seventh Congress, Second Session, Calendar No. 1627]

[June 28, 1962]

Mr. Byrd, from the Committee on Finance, submitted the following report together with minority views to accompany H.R. 12061.

The Committee on Finance, to whom referred the bill (H.R. 12061) to extend the Renegotiation Act of 1951, having considered the same, report favorably thereon, with amendments, and recommend that the bill as amended do pass.

I. GENERAL STATEMENT

The Renegotiation Act of 1951, which authorizes the Government to recapture excessive profits on certain Government contracts and related subcontracts, is scheduled to expire as of June 30, 1962. H.R. 12061 extends the act for 2 years, that is, until June 30, 1964.

The bill also makes certain other amendments to the act. One of these amendments prohibits the departments from inserting certain profit limitation provisions in contracts, another makes the standard commercial article exemption (and the related exemptions for "like" articles and for classes of articles) applicable to receipts or accruals from leases, and another amendment broadens the scope of appellate review of Tax Court decisions in renegotiation cases. These amendments are explained further below.

II. EXPLANATION OF THE BILL

Section 1. Extension of the Renegotiation Act.—The President, in his budget message to Congress earlier this year, recommended that the Renegotiation Act be extended. The Renegotiation Board subsequently transmitted to Congress a draft of proposed legislation to implement that recommendation, and recommended that the period of the extension be 4 years. The Joint Committee on Internal Revenue Taxation, in the report made by it to the House and to the Senate on January 31, 1962, pursuant to a directive contained in the 1959 legislation by which the act was last extended, also recommended that the act be extended, but recommended that the period of extension be 2 years. (See "Report on the Renegotiation Act of 1951," H. Doc. 322, 87th Cong., 2d sess.)

Your committee is aware, as was pointed out by the Renegotiation Board in its letter transmitting the draft of proposed legislation to extend the act, that the defense procurement program has involved " the expenditure of vast sums of mbony for the purchas of many different types of weapons and related materials * * *." The Board stated that "For the fiscal year 1962, it is estimated that expenditures for national defense will aggregate approximately $46.8 billion; and for the fiscal year 1963, it is estimated that such expenditures will be at least as great or greater."

Your committee is also aware, as was pointed out by the Board, that the defense procurement program requires the procurement of many highly specialized items of an unprecedented nature, as to which past production and cost experience is not always available for forecasting accurately the cost of such items. The Renegotiation Act provides one technique for eliminating excessive profits under contracts for the procurement of such items. For these reasons, your committee concluded that the Renegotiation Act must be extended.

This bill would extend the act for 2 years, as recommended by the Joint Committee on Internal Revenue Taxation, rather than for the 4 years originally recommended by the Renegotiation Board. Your committee has been advised that the newly constituted Renegotiation Board is now conducting a reexamination of the renegotiation process and that other departments in the administration are reviewing certain renegotiation matters with which they are concerned. Your committee believes that under these circumstances the act should be extended for only 2 years.

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[4] This publication of the Committee Report is restricted to excerpts involving internal revenue matters; Public Law 87–520, page 64, this Bulletin.

Section 4. Appellate review of Tax Court decisions in renegotiation cases.—Section 4 of the bill amends the act so as to broaden the scope of appellate review of Tax Court decisions in renegotiation cases.

The provisions of present law relating to appellate review of Tax Court decisions in renegotiation cases have been sharply criticized by many within the past several years. Although the courts have interpreted provisions of the Internal Revenue Code, which relate generally to appellate review of Tax Court decisions, as allowing some measure of appellate review of its decisions in renegotiation cases, the scope of review thus allowed by the courts has been quite limited, and considerably narrower than that accorded with respect to Tax Court decisions in tax cases. The problems and uncertainties presented by the present provisions of law concerning scope of appellate review of Tax Court decisions in renegotiation cases have been the subject of careful congressional study for several years, and on the basis of that study, your committee has concluded that the measure of appellate review now available is unduly restricted. With certain important exceptions, your committee believes that Tax Court decisions in renegotiation cases should be subject to appellate review in the same manner and to the same extent as its decisions in tax cases.

Accordingly, section 4 of your committee's bill provides for review by the U.S. courts of appeals (and by the Supreme Court of the United States upon certiorari) of Tax Court decisions in renegotiation cases, in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury, subject, however, to certain important limitations. The first limitation is that in no case shall the question of the existence of excessive profits, or the extent thereof, be reviewed, and, further, that findings of fact by the Tax Court shall be conclusive unless such findings are arbitrary or capricious. Your committee believes that the ultimate question of the extent of excessiveness of profits or of the existence thereof, requires the exercise of judgment which is of such a nature that the appellate courts should not be permitted to substitute their judgment for that of the Tax Court.

For this reason, your committee's bill also imposes other limitations on the power of the appellate courts in the provisions of subsection (b) of section 108A as amended by the bill. Under these provisions, the powers of the appellate courts are limited to affirming the decision of the Tax Court, or to reversing such decision on questions of law and remanding the case for such further action as justice may require. The appellate courts, moreover, are not permitted to reverse and remand the case for an error of law which is immaterial to the decision of the Tax Court.

There is also a provision in section 4 of the bill which the provision of existing law (the last sentence of sec. 105(b)(2) of the Renegotiation Act) which stops the accrual of interest provided for under the act after 3 years from the date of filing a petition for redetermination with the Tax Court in any case in which there has not been a final determination by the Tax Court with respect to the petition within such 3-year period.

In order to make the amendments made by section 4 of the bill prospective in effect, provision has been made in section 4 that the amendments made thereby shall apply only with respect to cases in which the petition for redetermination is filed with the Tax Court after the date of enactment of the bill.

MINORITY VIEW

In addition to extending the Renegotiation Act for a period of 2 years, that is, until June 30, 1964, this bill would amend the act in three significant respects, as indicated in the majority report. While I have no objection to extending the act for a period of 2 years, I strongly oppose the adoption of the proposed amendments to the act and do so for the following reasons.

First, it should be pointed out that the staff of the Joint Committee on Internal Revenue Taxation concluded in House Report No. 1447, after an extensive and exhaustive study that, except for extending the act 2 years, "the staff does not believe it would be advisable to suggest any basic changes in the act while the Renegotiation Board is conducting its reexamination of the renegotiation process."

(1) More specifically the staff, while recognizing that considerable criticism has been directed to the limitations imposed by present law on appellate review

of Tax Court decisions in renegotiation cases and to the litigation necessitated by the uncertainties under present law regarding the scope of appellate review, nevertheless concluded in its report that—

> It is the opinion of the staff that no change should be made at this time in those provisions of present law concerning the scope of appellate review of Tax Court decisions in renegotiation cases.

Acknowledging the many objections which may have been raised on the question of the scope of appellate review in renegotiation cases, it appears inadvisable to adopt amendments at this time which may have far-reaching effects and possibly create more uncertainties in the law without first conducting public hearings on the question of appellate review and of the issues raised by the other amendments.

This is especially true because the Supreme Court in the *California Eastern Line* case has ruled that the scope of review of renegotiation decisions of the Tax Court is fixed by the same provision of the Internal Revenue Code that defines the scope of review of tax decisions of that court. It follows that under present law the same right of review exists with respect to decisions of the Tax Court in renegotiation cases as in tax cases arising in that court, with the single exception that a Tax Court determination of the amount of excessive profits is not subject to review. Since the decision of the Supreme Court in 1955, there have been 11 cases in which various courts of appeals have assumed jurisdiction to review questions of law in renegotiation cases decided by the Tax Court. In four cases such jurisdiction has been refused. Since the proposed amendment would, on its face, merely codify the existing law as declared by the Supreme Court, it does not appear to me to be necessary.

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PAUL H. DOUGLAS.

[H.R. 6413] [5]

DECLARATION OF ESTIMATED INCOME TAX BY FISHERMEN

[Senate Report No. 1819, Eighty-seventh Congress, Second Session, Calendar No. 1776]

[August 3, 1962]

MR. BYRD of Virginia, from the Committee on Finance, submitted the following report to accompany H. R. 6413.

The Committee on Finance, to whom was referred the bill (H.R. 6413) to extend to fishermen the same treatment accorded farmers in relation to estimated income tax, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

I. SUMMARY OF HOUSE PROVISION

H.R. 6413 provides that, for purposes of the estimated income tax, fishermen are to be accorded the same treatment as presently is available for farmers. Under the amended bill this is to be provided for taxable years beginning after December 31, 1962.

The principal advantage to taxpayers having income from farming—which the bill extends to those having income from fishing—is the privilege of filing the declaration of estimated tax, and paying the estimated tax, by January 15 after the end of the year in question (in the case of a calendar-year taxpayer), rather than filing the declaration by the prior April 15 and making quarterly payments of estimated tax.

II. SUMMARY OF COMMITTEE AMENDMENT

Your committee's amendment makes the extra 10-percent limitation on deduction of charitable contributions (presently available in the case of contributions to a church, school, hospital, or medical research organization) available

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[5] Public Law 87–682, page 68, this Bulletin.

also in the case of contributions to an organization which normally receives a substantial part of its support from the United States or any State or political subdivision thereof or from direct or indirect contributions from the general public, organized and operated exclusively to receive, hold, invest, and administer property and to make expenditures to or for the benefit of a State university or college, including a land-grant college or university. This provision, which is added by your committee, is to apply to taxable years beginning after December 31, 1960.

III. GENERAL EXPLANATION OF HOUSE PROVISION

Under present law those who derive two-thirds or more of their income from farming (including oyster farming) are in several respects treated differently than taxpayers generally under the system of declarations of estimated tax.

First, taxpayers other than farmers who have sufficient income are required to make an estimate on April 15 (in the case of a calendar-year taxpayer) of tax in excess of that withheld and pay this amount in four quarterly payments on April 15, June 15, September 15, and January 15 (sec. 6073(a)).[6] However, farmers, instead of making the estimate in April and paying the quarterly installments, may file an estimate by January 15 of the following year, paying the full estimated tax at the time of filing (secs. 6073(b) and 6153(b)).

Second, taxpayers other than farmers, instead of making their fourth payment of estimated tax on January 15 (in the case of calendar-year taxpayers), are permitted to file their regular income tax return and make their final tax payment by January 31 (sec. 6015(f)). In the case of farmers this date is February 15 instead of January 31.

Third, present law for taxpayers other than farmers bases the 6 percent per annum addition to tax on the excess of 70 percent of the actual tax due over the amount paid by withholding and by estimated tax (sec. 6654(b)). For farmers this percentage is 66⅔ percent instead of 70 percent.

Fourth, there are four exceptions, or "escape valves" as they are sometimes called (in sec. 6654(d)), which, if any apply, mean that no 6 percent per annum addition to tax is to be made for underpayment of estimated tax. One of these exceptions, or escape valves, provides that in the case of any installment, there is to be no addition to tax if, in the case of taxpayers other than farmers, 70 percent of what the tax would be (determined on an annualized basis) for the part of the year up to the installment due date has been paid by that time (sec. 6654(d)(1)(C)). For farmers this percentage is 66⅔ percent.

There are several reasons why this different treatment was provided in the case of taxpayers with income from farming. Probably the most important reason was the recognition that income from farming is particularly difficult to estimate before the end of the year, or at least before the end of the principal crop season. Also, the income receipts are likely to be concentrated in the latter part of the year in the case of farming. Furthermore, accurate recordkeeping is probably more of a problem in the case of farming than for most other self-employment income.

Your committee believes that the reasons cited above for the different estimated tax treatment for farming apply in most respects in the case of income of individuals from fishing. Therefore, the bill adds the phrase "or fishing" after each reference to farming in sections 6015(f), 6073(b), 6153(b), and 6654 (b) and (d)(1)(C). In addition, the bill makes technical conforming changes.

The changes made by the bill as amended are to be effective with respect to declarations of estimated tax relating to the calendar year 1963 and subsequent taxable years.

IV GENERAL EXPLANATION OF COMMITTEE AMENDMENT

Your committee's amendment adds a new category (clause (iv)) to section 170(b)(1)(A) of the Internal Revenue Code, relating to organizations which qualify for the extra 10-percent deduction for charitable contributions. The new category added by your committee's amendment comprises organizations, which normally receive a substantial part of their support from the United States or any State or political subdivision thereof or from direct or indirect contributions

[6] Amendments of declarations of estimated tax may also be made by the payment dates for each quarter of the year.

from the general public, organized and operated exclusively to receive, hold, invest, and administer property and to make expenditures to or for the benefit of a State university or college, including a land-grant college or university. The purpose of this provision is to extend the extra 10-percent limitation on deductions for charitable contributions to a university endowment association, the activities of which include encouraging and soliciting private support for the university, receiving and holding in trust all property given to the association for the benefit of the university or college, the administration of the endowment funds, and the maintenance of separate funds for gifts and bequests received for uses for which State-appropriated funds are not available or are insufficient, such as scholarships, student loans, equipment, furnishings, supplies, lectureships, and libraries. In some instances, university endowment institutions of the type included by your committee's amendment hold title to property comprising part of the campus area of a college or university, and participate in the erection of university buildings. In general, these foundations do a variety of things which are normally accepted functions of colleges and universities. They merely do them through separate corporations rather than through the university corporation.

Because the functions of these university endowment foundations are so similar to functions normally performed directly by colleges and universities, your committee does not believe that the extra 10-percent deductions should be denied in the case of contributions made to such foundations.

Moreover, the attention of your committee has been called to the fact that in at least 9 States [7] legal restrictions limit the ability of State and land-grant colleges or universities to receive directly gifts and bequests from the public for particular purposes. This is especially true of gifts not made in trust. Because of these restrictions, endowment foundations have been created in connection with many State colleges and universities (often by alumni groups) for the purpose of receiving gifts and bequests from the general public and of making expenditures for the benefit of such colleges and universities. Private universities or colleges, on the other hand, are not similarly restricted in their ability to receive gifts and bequests directly. Accordingly, your committee has limited the scope of its amendment to endowment foundations which normally receive substantial support from the Federal or State Government or political subdivisions thereof or from direct or indirect contributions from the general public established to make expenditures to or for the benefit of State colleges and universities, including land-grant colleges and universities. Moreover, this limitation will prevent private foundations from qualifying for the extra 10-percent deduction under this provision.

This provision (clause (iv) of sec. 170(b)(1)(A) of the code) is to apply to taxable years beginning after December 31, 1960.

[H.R. 12526] [8]

NET OPERATING LOSS CARRYOVERS FOR CERTAIN REGULATED TRANSPORTATION CORPORATIONS

[Senate Report No. 2041, Eighty-seventh Congress, Second Session, Calendar No. 2007]

[September 13, 1962]

Mr. Byrd of Virginia, from the Committee on Finance, submitted the following report together with supplemental views to accompany H.R. 12526.

The Committee on Finance, to whom was referred the bill (H.R. 12526) to amend section 172 of the Internal Revenue Code of 1954 to provide a 7-year net operating loss carryover for certain regulated transportation corporations, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

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[7] Iowa, Kansas, New York, Oregon, South Dakota, Utah, Virginia, West Virginia, and Wisconsin.

[8] Public Law 87–710, page 69, this Bulletin.

SUMMARY OF BILL

Corporations generally may carry net operating losses back 3 years and then, if there is any remaining unused loss, forward for 5 years. This bill provides that regulated transportation corporations, in addition to the 3-year carryback, are to have a 7-year, instead of a 5-year, carryforward of net operating losses. This longer period to carryforward net operating losses is to be available to these corporations with respect to losses occurring in years, or portions of years, occurring since December 31, 1955.

This bill has been reported unanimously by your committee. This bill in large measure follows the recommendation of the President in his message on transportation. In that report he recommended a 7-year, instead of a 5-year, carryforward period for the losses of regulated public utilities.

REASONS FOR THE BILL

The President in his message to Congress on April 5, 1962, relating to the transportation system of our Nation, stressed the importance of an efficient and dynamic transportation system to aid in obtaining domestic economic growth, productivity, and progress. As he indicated, our transportation system affects the cost of every commodity we consume or export and is equally vital to our ability to compete abroad. One recommendation of the President in his transportation message was as follows:

> In addition, I recommend that the Internal Revenue Code be amended to increase from 5 to 7 years the period during which regulated public utilities, including those in transportation, can apply prior year losses to reduce current income for tax purposes.

The regulated transportation companies, particularly the railroads, have greater need for long carryforwards of net operating losses than other companies because they tend to have relatively lower rates of earnings. Because of these lower earnings, such companies when they have losses require a longer period of time, than do most other companies, before these losses can be offset in full against earnings of other years. The fact that these companies are regulated in the price they can charge also tends to make it more difficult for them to recoup these losses in earnings' years. This has been an especially important problem in the case of the railroads whose earnings have declined over 40 percent in the period between 1955 and 1959, with further declines having occurred since that time. In fact, your committee has been informed that at least seven railroads have unused net operating loss carryforwards which lapse at the end of this year. These are the Pennsylvania, the New York Central, the Erie-Lackawanna, the New York, New Haven & Hartford, the Boston & Maine, the Chicago & North Western, and the Lehigh Valley Railroads. In view of these considerations, your committee's bill provides that for losses occurring in taxable years, or a portion of a year, after December 31, 1955, these regulated transportation companies are to have 7 years, rather than the usual 5-year period, over which losses may be carried forward:

GENERAL EXPLANATION

Corporations generally may carry a net operating loss back to the three immediately prior taxable years and then if any loss still remains, this amount may be carried forward to each of the 5 succeeding years. This bill provides, however, that a net operating loss from any taxable year ending after December 31, 1955, in the case of a "regulated transportation corporation" may be carried forward 7 years instead of 5. This is in addition to the 3-year carryback which is generally applicable. For corporations with loss years partially in 1955 and partially in 1956 a special rule described below limits the benefit of the longer loss carryforward to the portion of the year in 1956.

A regulated transportation corporation, for purposes of this 7-year net operating loss carryover includes any corporation receiving 80 percent or more of its gross income (without regard to dividends and capital gains and losses) from the furnishing or sale of certain specified types of transportation. The forms of transportation which are included are—

(1) Transportation by common carrier by a railroad subject to the jurisdiction of the Interstate Commerce Commission;

(2) Other transportation on an intrastate, suburban, municipal, or interurban electric railroad or trackless trolley system if its rates are established or approved by a governmental body or agency;

(3) Transportation on a municipal or suburban bus system if its rates are established or approved by a governmental body or agency;

(4) Other transportation by motor vehicle if the rates had been established or approved by a regulated body or agency;

(5) Transportation by common carrier by air subject to the jurisdiction of the Civil Aeronautics Board; and

(6) Transportation by common carrier by water subject to the jurisdiction of the Interstate Commerce Commission or Federal Maritime Board under the Intercoastal Shipping Act.

Also included are railroad corporations which have leased their railroad properties to another railroad and parent corporations of railroads. Finally, a corporation is included it it is a member of a "regulated transportation system." A regulated transportation system for this purpose is any corporation which is a member of an affiliated group filing a consolidated return if 80 percent of the aggregate gross income is derived from sources described in the listing Nos. 1 to 6 above or from a lessor railroad or common parent railroad. "Aggregate gross income" means the combined gross income of all of the members of the group without any eliminations for intercompany transactions.

The bill provides that for the net operating loss carryover to be available for the sixth year, the taxpayer involved must be a "regulated transportation corporation" for that year. For a loss to be carried to its seventh year the taxpayer involved must have been a "regulated transportation corporation" for both the sixth and the seventh years.

The bill also provides a proration formula which limits the loss which can be carried over from a year beginning in 1955 and ending in 1956. The formula provides that any loss carried over the sixth year in such cases is to be the same proportion of any loss remaining at the end of the fifth year which the number of days in the taxpayer's 1955–56 year which were in the calendar year 1956 bears to the total number of days in that year. Any of this partial loss remaining after the offset against income in the sixth year may then be carried forward and offset against income in the seventh year.

DEPARTMENTAL VIEWS

The Treasury Department has no objection to enactment of this bill.

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SUPPLEMENTARY STATEMENT BY SENATOR PAUL DOUGLAS

No hearings were held on this bill either in the House or in the Senate. It is impossible therefore to determine whether or not it is in the public interest. I think this is poor procedure and that therefore this bill probably needs more thorough scrutiny.

We have drifted into loose procedures on these bills rushed through at the end of the session. They have been going through Congress with little examination and this has sometimes had unfortunate results. I believe our Senate procedures should be revised to provide for a more thorough examination of their possible merits and demerits. In the meantime the Senate should in my opinion go slow.

SUPPLEMENTARY STATEMENT BY SENATOR HARRY F. BYRD, CHAIRMAN

The Senate Finance Committee, in formal meeting September 10, 1962, ordered to be reported 11 bills with recommendations that they be considered favorably by the Senate. This bill was among those ordered to be reported at that time.

As a member of the committee, the Senator from Illinois (Mr. Douglas) voted against committee approval of all of these bills except one. He voted affirmatively to report only H.R. 12529 which affected his State.

He voted against reporting all other bills before the committee on that date with the statement that he was voting in the negative because public hearings had not been held.

In his supplementary statements on these bills the Senator from Illinois creates the impression—intentional or not—that the Finance Committee is not giving proper and adequate attention to legislation reported to the Senate.

With respect to all of these bills he apparently tries to leave the inference that the committee has drifted into a loose procedure of rushing bills through at the end of the session which he claims produces unfortunate results.

On behalf of the majority of the Senate Finance Committee I want to make it clear to the Senate that, in the case of the bills ordered to be reported by the committee on September 10, 1962—

1. Each of the bills has been passed by the House of Representatives;
2. No request was made for Senate hearings on these bills, and this includes the bill for which the Senator from Illinois voted in the affirmative;
3. Each of the bills ordered to be reported, except H.R. 12529 in which the Senator from Illinois is interested, was formally approved by the executive agencies having jurisdiction over their administration;
4. The contents of each bill were fully outlined by the members of the committee staff, and discussed by members of the committee; and
5. When the committee voted, members had full knowledge of the purpose and effcts of the proposed legislation.

Momentous matters are referred to the Senate Committee on Finance, including legislation with respect to taxation, tariffs and customs, social security, veterans, etc., and the committee has always been meticulous in exploring the effects of all legislation it recommends.

The current tax bill—H.R. 10650—now in conference is a case in point. More than 200 witnesses were heard on this bill, and the legislation was under committee consideration more than 4 months.

The Senator from Virginia cannot recall that the Senate has rejected a bill recommended by the Senate Finance Committee. It suffices to say that when the need for hearings is indicated, the committee will hold them.

The procedure followed by the committee in consideration of the agenda for the meeting of September 10 involved no departure from committee practice over the 30 years during which I have been a member.

The committee always holds hearings when they are necessary for the enlightenment of the membership, and the procedure of the past, so far as the chairman is concerned, will be continued in the future.

[H.R. 12775][9]

PLACING AUTHORITY OVER THE TRUST POWERS OF NATIONAL BANKS IN THE COMPTROLLER OF THE CURRENCY

[Senate Report No. 2039, Eighty-seventh Congress, Second Session, Calendar No. 2005]

[September 13, 1962]

Mr. Robertson, from the Committee on Banking and Currency, submitted the following Report to accompany H.R. 12577.

The Committee on Banking and Currency, to whom was referred the bill (H.R. 12577) to place authority over the trust powers of national banks in the Comptroller of the Currency, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

PURPOSE OF BILL

H.R. 12577 would transfer from the Board of Governors of the Federal Reserve System to the Comptroller of the Currency authority to grant trust powers to

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[9] Public Law 87–722, page 70, this Bulletin.

national banks and to issue regulations governing the exercise of such powers. This power is now conferred upon the Board by subsection (k) of section 11 of the Federal Reserve Act, which this bill repeals. No change would be made from the substantive provisions of section 11(k) other than the transfer of authority, so that there is no alteration of existing law regarding national banks acting in fiduciary capacities. Section 2 contains a saving clause, to make clear that nothing contained in the bill would affect or curtail the right of any national bank to exercise trust powers under a permit previously issued by the Board of Governors of the Federal Reserve System.

Section 4 of the bill would amend section 584 of the Internal Revenue Code, regarding common trust funds, to provide for the fact that regulations concerning such funds would be issued by the Comptroller of the Currency, rather than the Board of Governors of the Federal Reserve System, as a result of this bill. Reference to rules and regulations issued by the Board pertaining to such funds would be left in that section to give continued validity to actions taken heretofore in reliance upon the Board's regulations. However, since the preceding sections of the bill would transfer such authority to the Comptroller, the continued reference to the Board in that section would have no effect as to future common trust fund questions, which would depend instead upon the regulations of the Comptroller, under the bill. The last section of the bill would amend section 581 of the Internal Revenue Code to reflect the fact that H.R. 12577 would repeal section 11(k) of the Federal Reserve Act and would place these matters under the authority of the Comptroller.

GENERAL STATEMENT

In the legislative recommendations of the Federal supervisory agencies to the Senate Committee on Banking and Currency (committee print, 84th Cong., 2d sess.) the Comptroller of the Currency expressed the opinion that this power should be transferred. Then, as now, the Board of Governors stated that it had no objection, but recommended that the regulation of common trust funds also be transferred. This bill would carry out that recommendation. At the time national banks were first permitted to engage in trust activities, the power to grant them permission to do so was given to the Board. However, this section applies only to national banks and not to State member banks. Since national banks, including their trust departments, are supervised by the Comptroller of the Currency, the power to grant and regulate their authority to act as trustees should logically rest with that Office rather than with the Board. On the basis of his general supervisory functions with respect to national banks, the Comptroller has adequate information upon which to decide whether a particular bank should be allowed to exercise trust powers, and to formulate regulations governing the exercise of such powers.

Under section 584 of the Internal Revenue Code, all banks, State or National, must conform to regulations of the Board of Governors of the Federal Reserve System with respect to collective investment of trust funds of national banks in order to qualify for income tax exemption of their common trust funds. Under the bill, State banks must conform to regulations issued by the Comptroller of the Currency pertaining to the collective investment of trust funds by national banks. However, this bill will result in no change in the present distribution of power between Federal and State Governments, nor will it cause any weakening of the principles underlying the dual banking system. The Internal Revenue Code requires that, for tax purposes, regulations applicable to the collective investment of trust funds be issued at the Federal level. This bill would shift existing authority from one Federal agency to another. It would not give authority to the Comptroller of the Currency to exercise any supervisory functions over State banks. Federal income tax regulations as to common trust funds would continue to be uniform for all banks, State and National.

Hearings were held on H.R. 12577 on August 30, 1962. The three Federal bank supervisory agencies supported the bill.

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[H.R. 8824][10]

EXCEPTION OF CERTAIN CONSUMER FINANCE COMPANIES FROM PERSONAL HOLDING COMPANY TAX

[Senate Report No. 2047, Eighty-seventh Congress, Second Session, Calendar No. 2013]

[September 13, 1962]

Mr. Byrd of Virginia, from the Committee on Finance, submitted the following report together with supplemental views to accompany H.R. 8824.

The Committee on Finance, to whom was referred the bill (H.R. 8824) to modify the application of the personal holding company tax in the case of consumer finance companies, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

SUMMARY OF BILL

Certain exceptions to the tax on personal holding companies are made under existing law for companies receiving dividend, interest, or other income from the active conduct of a trade or business, rather than from passive investments. Among these exceptions under present law is one for certain lending companies engaged in the small loan business.

This bill modifies this exception to conform it with the laws many States have been enacting in recent years for the regulation of consumer finance business. Thus, under this bill as amended, two of the present requirements are deleted; namely, the requirement that interest and similar charges on most of the loans not exceed a simple interest rate of 3 percent per month not payable in advance and on unpaid balances, and the requirement that most of the loans be for periods of not more than 36 months. The bill also modifies the requirement that 80 percent of the company's income be derived from interest and similar charges to provide that this 80 percent may also include lawful income received from an 80-percent-owned domestic subsidiary. Another modification increases from $500 to $1,500 the maximum size of the loans, where no maximum is set by State statute, which must account for 60 percent of the company's gross income. On the other hand, the bill also provides that the lending company must be actively engaged in the small loan (consumer finance) business.

GENERAL STATEMENT

Under present law a special tax of from 75 to 85 percent is imposed on undistributed personal holding company income. This tax is designed to prevent the avoidance of the graduated individual income tax by placing investment funds in a corporation and retaining the income at the corporate level. This is what has become known as an "incorporated pocketbook." In general terms a corporation is a personal holding company if five or fewer individuals own more than 50 percent of the value of the outstanding stock and if 80 percent or more of the corporation's income is "personal holding company income." Personal holding company income in general consists of "passive" income, i.e., with certain exceptions includes dividends, interest, annuities, gains from the sale of stock or securities, rents, etc.

Present law provides, however, that the term "personal holding company" does not include certain types of companies although they derive their income from the sources referred to above. The exceptions are provided because the types of companies involved are engaged in an active trade or business despite the nature of their income. Thus, the exceptions include banks, life insurance companies, licensed personal finance companies, and lending companies engaged in the small loan business. It is this latter exception with which this bill is concerned.

The conditions which under present law a lending company engaged in a small loan business must meet in order to be exempt from the personal holding company tax are quite detailed. They must—

(1) Be authorized to engage in the small loan business under one or more State statutes providing for the direct regulation of such business;

(2) Derive 80 percent or more of their gross income from lawful interest, discount, or other authorized charges;

[10] Public Law 87–768, page 85, this Bulletin.

(3) Derive the 80 percent of their income, referred to above, from loans maturing in not more than 36 months made to individuals in accordance with the provisions of applicable State law;

(4) Derive this 80 percent of their income from loans where the interest and all other authorized charges do not exceed the amount equal to simple interest computed at the rate of 3 percent per month not payable in advance and only on unpaid balances;

(5) Derive 60 percent of their gross income from lawful interest, discount, other lawful authorized charges received from individuals whose indebtedness to the company does not exceed the limit prescribed by the applicable State law, or, if there is no such limit, $500;

(6) Have trade or business expense deductions (other than compensation for personal services rendered by shareholders or members of their family) equal to 15 percent or more of their gross income;

(7) Have outstanding loans with respect to any person who is a shareholder having a 10-percent interest in the stock of the company (including stock owned by members of the family) or not in excess of $5,000.

The exception in present law for licensed personal finance companies (sec. 542(c)(6)) was added to the Internal Revenue Code by the Revenue Act of 1938 to grant exemption from personal holding company taxation for companies operating under statutes similar to the Uniform Small Loan Act drafted by the Russell Sage Foundation. Under this law, interest could not be payable in advance or compounded and could be computed only on unpaid balances. The exception described above for lending companies making small business loans (sec. 542(c)(7)) was added to the code in 1950 at the request of those who live in States which allowed interest charges to be determined by the "dollar add on" or precomputed interest method. Presently, there are 23 States which allow interest charges to be computed in this manner.

Under the precomputation method, simple interest is computed in advance as though the contract were to be repaid according to its terms, the computation is added to the principal and the total is divided into equal payments. Under the dollar-add-on method the interest and other charges are expressed in dollars rather than percentages, and computed on the original amount of the loan for the full period. This amount is then added to the net loan and the result divided into equal payments. The requirement that the interest, although computed on the precomputed or dollar-add-on basis must not exceed the 3-percent-simple-interest method, described above (No. 4), has presented serious problems in that every lender has to measure the difference between the interest it receives under the precomputation or dollar-add-on method and what it would be permitted to receive under the 3-percent-simple-interest method. It then must exclude any excess over the 3-percent-simple-interest method, in determining whether the balance meets the percentage tests for the exemption.

This bill omits this 3-percent-simple-interest requirement entirely, on the grounds that the personal holding company tax is not intended as a means of regulating the lending companies but rather as a tax applicable in certain cases, to passive investments. In any event, this is an ineffectual regulatory device since this restriction applies only to about 10 percent of the outstanding small loans. This occurs because the bulk of the small loans are made by widely held finance companies, and therefore not treated as personal holding companies since they do not have five or fewer stockholders owning more than 50 percent of their stock. Moreover, even the companies presently subject to this restriction need to meet it only with respect to 80 percent of their gross income.

In view of the factors outlined above, your committee believes that it is inappropriate to continue this 3-percent-simple-interest requirement and this bill deletes it from the restrictions imposed with respect to these lending companies.

The bill also deletes the requirement that these lending companies derive most of their income from loans maturing in not more than 36 months. Several States already have gone beyond this as a permissive period for loans and it appears likely that in the near future a number of additional States may extend maturities to more than 36 months. Your committee agrees with the House committee that it should not impose a requirement substantially more restrictive in nature than the State laws regulating this type of lending company.

A third change made by the House bill modifies the maximum size of a loan which may qualify under the 80-percent-income requirement where there is no State law governing the maximum size of a loan. Under present law where there is no such limit under State law, a limitation of $500 is provided.

Under the bill this limitation is increased to $1,500. It is understood that the only State which does not have a ceiling of its own is the State of California. When the $500 limit provided by present law was considered, this represented the usual ceiling among the States. The States have changed these ceilings materially, however, with the result that today relatively few States have a ceiling of $500 or less and even in these cases there usually is provision for supplementary loans which exceed this ceiling in certain situations. The $1,500 provided by this bill, where there is no applicable State limitation, today is substantially in conformance with the ceilings applicable in those States providing their own maximums.

A fourth modification under the bill provides that 80 percent of the company's gross income need not be derived only from loans but also may include lawful income received from a domestic subsidiary (in which the corporation in question has at least 80 percent of the voting power of all classes of stock and owns at least 80 percent of the nonvoting stock) if the subsidiaries are themselves excepted from personal holding company tax under either this same exception (par. (7)) or as a licensed personal finance company (par. (6)), a loan or investment company (par. (8)), or a finance company (par. (9)). Your committee agrees with the House that the mere fact that income is received from a subsidiary which itself meets the same requirements as the company in question, or similar requirements, should not result in such a company being subjected to personal holding company tax. It will still be necessary, however, for the companies involved to meet directly the 60 percent gross income requirement.

A fifth change relates to the use of the term "small loan business," which represents the type of business in which a lending company must be engaged in order to be removed from application of the personal holding company tax under this exception. The bill adds after the term "small loan business" the term "(consumer finance business)". This is intended to make it clear that this exception is not limited to small loans in the narrow sense, but rather is intended to encompass consumer finance loans generally. Moreover, the reference to consumer finance business will bring this exception more directly in accord with the terminology now used by a number of State legislatures which have retitled the applicable provisions governing these institutions as "consumer finance laws" as a means of providing a more descriptive title for the type of business involved.

The provisions described above liberalize the exception provided for lending companies engaged in the small loan or consumer finance business. However, the House bill has also added a provision which is restrictive in its application. It has provided that these lending companies must not only be authorized to engage in the small loan or consumer finance business but also must be "actively and regularly engaged in" such business. This gives assurance that such companies cannot be used indirectly as holders of passive investment income or as "incorporated pocketbooks."

Your committee believes that the changes made by this bill are desirable because they conform the exception in existing law to changes which have occurred in the industry since the passage by Congress of this exception in 1950. They also will enable the smaller, closely held companies to compete on even terms with the larger publicly owned chain organizations.

DEPARTMENTAL REPORT

The bill was amended by the House Ways and Means Committee so as to incorporate certain changes recommended by the Treasury Department. Thus, the Treasury Department has no objections to the enactment of H.R. 8824 as indicated in the following report:

TREASURY DEPARTMENT,
Washington, July 23, 1962.

HON. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: This is in reference to H.R. 8824, now pending before your committee, to modify the application of the personal holding company tax in the case of consumer finance companies.

The bill would amend section 542(c)(7) of the Internal Revenue Code of 1954. That section exempts certain lending companies from taxation as personal holding companies.

To qualify under section 542(c)(7) the company must be (1) authorized to engage in the small loan business under State statutes providing for the direct regulation of such businesses; (2) 80 percent of the gross income must be from loans; (3) made to individuals; (4) maturing in not more than 36 months; (5) the interest, discount, and other authorized charges from which do not for any loan exceed 3 percent per month not payable in advance and computed only on unpaid balances. In addition, (6) at least 60 percent of the gross income must be lawful interest, discount, or other authorized charges received from individuals each of whose indebtedness did not at any time during the taxable year exceed in principal amount the limit prescribed for small loans by the State law (or if there is no such limit, $500); (7) deductions under section 162, other than compensation for personal services rendered by shareholders, must constitute 15 percent or more of gross income; (8) loans to a person by, or for, whom 10 percent or more in value of the small loan companies' outstanding stock is held must not at any time during the taxable year exceed $5,000.

The proposed bill changes qualifications (1), (2), and (6) and deletes qualifications (4) and (5). The requirement that 80 percent of gross income be interest, discount, or other authorized charges from loans is modified to require that 80 percent of gross income consist of either or both of two categories of income; the first category consists of the type of income presently required and the second category consists of lawful income received from 80-percent-owned domestic subsidiaries which are themselves excepted under paragraph (6), (8), or (9) of section 542(c). The authorization to engage in the "small loan business" is clarified to indicate that "small loan business" includes "consumer finance business" and the limit of $500 mentioned under qualification (6) is raised to $1,500.

Sections 541 through 547 of the Internal Revenue Code of 1954 set forth a series of rules for the taxation of so-called personal holding companies. The purpose of these provisions is to prevent taxpayers from using a corporation in order to shield their investment income from the high individual rates of taxation. Speaking generally, a corporation is a personal holding company if five, or fewer, individuals control as much as 50 percent of its stock and if 80 percent of its income is "personal holding company income." Personal holding company income is defined in section 543 to include, among other things, dividends and interest. Current earnings of a personal holding company which have not been distributed as dividends are subject, in addition to the usual corporate tax, to a surtax of 75 percent of undistributed income not in excess of $2,000 and 85 percent of the undistributed income in excess of that amount.

Section 542(c) enumerates corporations, 80 percent or more of whose income would normally be personal holding company income, which have been exempted from taxation as personal holding companies because they are operating companies. Subsections (6) through (9) have to do with companies in various phases of the lending business. These provisions treat similar problems and amendment of any one of them can be assessed only if comparison is made with the others. The pertinent sections for the purposes of assessing H.R. 8824 are subsections (6), (7), and (9)(C).

Subsection (6) exempts licensed personal finance companies if 80 percent of their gross income is lawful interest received from loans made to individuals in accordance with State law, and if at least 60 percent of their gross income is attributable to interest from loans made to individuals under State small loan laws. The interest on these latter loans must be "not payable in advance or compounded and computed only on unpaid balances." Finally, subsection (6) contains certain restrictions on loans to stockholders.

Finance companies which are "actively and regularly engaged in the business" are exempted from taxation as personal holding companies under certain conditions prescribed by section 542(c)(9). As far as here relevant, a finance company is exempted under section 542(c)(9)(C) if at least 80 percent of its gross income either is derived from a finance business carried on in accordance with State law or is not personal holding company income, and if 60 percent of gross income comes from specified transactions, one of which is loans, secured by personal property, to individuals in an amount greater than the small loan limit but less than $5,000. In addition, to qualify under subsection (9) the deductions allowable under section 162, other than compensation to shareholders or members of a shareholder's family, must constitute an amount equal to at least 15 percent of gross income. Finally, there is a restriction concerning loans to shareholders.

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The complex form of section 542(c)(7) has its origins in the attempt to make that section parallel the small loan laws of the States at the time of its enactment. To some extent also the statute may have been more tightly drawn than section 542(c)(6) as an indication of congressional disapproval of the precomputed and dollar-add-on methods of interest computation. Section 542(c)(6) of the Internal Revenue Code of 1954 as originally added to the code by the Revenue Act of 1938 was intended to grant exemption from personal holding company taxation to companies which operated under statutes similar to the uniform small loan law drafted by the Russell Sage Foundation.[11] Under this statute interest could not be payable in advance or compounded, and could be computed only on unpaid balances. Section 542(c)(7) of the Internal Revenue Code of 1954 was added to the code in 1950 at the request of those who lived in States which allowed charges to be determined by the dollar-add-on or precomputed interest method. Presently there are 23 States which allow interest charges to be computed in this manner.

The Treasury Department is deeply concerned with the problems presented by small loans, but believes that the limitations presently contained in section 542(c)(7) are ineffectual regulatory instruments in view of the changes in State law since enactment of those limitations in 1950.

The 3-percent-per-month rule is the most important of those prescribed by section 542(c)(7). In the first place, this rule applies only to those finance companies of which five or less stockholders own at least 50 percent of the stock. Since only 80 percent of gross income need meet the 3-percent-per-month test even these companies can charge above this amount on some of their loans. Of course, there is no Federal limit on interest if it is computed under section 542(c)(6). Although it has been impossible to completely assess the effect of section 542(c)(7), the fact that its rules apply only to part of the income of part of the industry part of the time makes this tax statute seem an inadequate regulatory instrument. Figures given to this Department by the Federal Reserve Board and by industry representatives indicate that the restrictions contained in section 542(c)(7) apply to 10 percent of outstanding small loans.[12]

It has been the Department's consistent position that taxpayers in like situations should be subject to the same rules and rates of taxation. The effectiveness of our self-assessing system to a large extent depends upon each taxpayer's willing compliance with laws which are regarded as rational and fair. Since section 542(c)(7) selects only a portion of the small loan industry for regulation, and since that portion is similar to other businesses not subject to these rules, the Department has no objection to the removal of the 3-percent-a-month and 36-month regulatory limitations.

The limit of $500 which applies when the State small loan law has no limit would be amended by the bill to $1,500. We have been informed that only California and Missouri would be affected by this amendment. The remaining States have raised their maximum dollar limitations from the original limit of $300 contained in the Russell-Sage law. For example, Oregon allows small loans up to $1,500. The Department has no objection to the proposed amendment.

It is estimated that enactment of H.R. 8824 would have no significance revenuewise.

Accordingly, the Department is not opposed to enactment of H.R. 8824.

The Bureau of the Budget has advised the Treasury Department that there is no objection from the standpoint of the administration's program to the presentation of this report.

Sincerely yours,

STANLEY S. SURREY,
Assistant Secretary.

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[11] Robinson & Nugent, "Regulation of the Small Loan Business" (Russell Sage Foundation, 1935).

[12] Companies with outstanding loans over $25 million account for 69 percent of outstanding loans. Another 11 percent of outstanding loans have been made by companies with total outstanding loans of $5 to $25 million. The remaining 20 percent of outstanding loans come from companies whose total outstanding loans amount to less than $5 million. Although the Department does not have precise figures as to the stock distribution of these companies, it is the Department's estimate, concurred in by the Federal Reserve Board and industry economists, that personal holding company stock ownership is found only among companies with total outstandings of less than $5 million. Of these it is estimated that only one-half are subject to the personal-holding-company provisions.

SUPPLEMENTARY STATEMENT BY SENATOR PAUL DOUGLAS

No hearings were held on this bill either in the House or in the Senate. It is impossible therefore to determine whether or not it is in the public interest. I think this is poor procedure and that therefore this bill probably needs more thorough scrutiny.

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On behalf of the majority of the Senate Finance Committee I want to make it clear to the Senate that, in the case of the bills ordered to be reported by the committee on September 10, 1962:

(1) Each of the bills has been passed by the House of Representatives;

(2) No request was made for Senate hearings on these bills, and this includes the bill for which the Senator from Illinois voted in the affirmative;

(3) Each of the bills ordered to be reported, except H.R. 12529 in which the Senator from Illinois is interested, was formally approved by the executive agencies having jurisdiction over their administration;

(4) The contents of each bill were fully outlined by members of the committee staff, and discussed by members of the committee; and

(5) When the committee voted, members had full knowledge of the purpose and effects of the proposed legislation.

Momentous matters are referred to the Senate Committee on Finance, including legislation with respect to taxation, tariffs and customs, social security, veterans, and so forth, and the committee has always been meticulous in exploring the effects of all legislation it recommends.

The current tax bill—H.R. 10650—now in conference is a case in point. More than 200 witnesses were heard on this bill, and the legislation was under committee consideration more than 4 months.

The Senator from Virginia cannot recall that the Senate has rejected a bill recommended by the Senate Finance Committee. It suffices to say that when the need for hearings is indicated, the committee will hold them.

The procedure followed by the committee in consideration of the agenda for the meeting of September 10 involved no departure from committee practice over the 30 years during which I have been a member.

The committee always holds hearings when they are necessary for the enlightenment of the membership, and the procedure of the past, so far as the chairman is concerned, will be continued in the future.

[H.R. 6682] [13]

FOWLING NETS

[Senate Report No. 1607, Eighty-seventh Congress, Second Session, Calendar No. 1567]

[June 21, 1962]

Mr. Byrd of Virginia, from the Committee on Finance, submitted the following report to accompany H.R. 6682.

The Committee on Finance, to whom was referred the bill (H.R. 6682) to provide for the exemption of fowling nets from duty, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

I. PURPOSE

The purpose of H.R. 6682 is to provide for the duty-free entry of nets or sections or parts of nets, finished or unfinished, of whatever material or materials composed, for use in taking wild birds under licenses issued by an appropriate Federal or State governmental authority.

Your committee has added two provisions to this bill. One of these provides for the period from October 1, 1952, through August 31, 1955, that under certain conditions television tubes could be purchased tax-free for incorporation in television tuners and similar nontaxable articles which subsequently are sold for use in taxable television sets. Second, your committee's bill provides that local (usually cooperative) advertising which may be excluded from the sales price to which the various manufacturers' excise tax rates apply may include advertising in magazines and on outdoor advertising signs or posters.

II. GENERAL STATEMENT

H.R. 6682 would transfer from the dutiable to the free list of the Tariff Act of 1930 articles which are known as fowling nets. Fowling nets are used by organizations and persons engaged in banding of birds. The nets are used to temporarily capture birds and are designed to facilitate quick banding and release of the birds. Birdbanding activities, which are carried out primarily under the coordination and sponsorship of the U.S. Department of the Interior, assist interested parties in learning more about bird distribution, population, and migration and their determinants. For example, banding of blackbirds, which in some areas are exceedingly detrimental to cereal crops, has resulted in establishing the area from which the harmful birds originate, which in turn makes it now possible to apply control measures without indiscriminate destruction of blackbirds.

Birdbanding activities are primarily carried on by volunteer workers who receive no pay for their activities. The records obtained as a result of these activities are turned over to the U.S. Government and are used in research. The Government supplies the birdbands and the record forms. Each volunteer bander supplies his own traps or nets, bait, and other equipment necessary for him to perform the banding function.

The Department of Commerce has reported that it knows of no domestic production of fowling nets. The Departments of State, Treasury, Interior, and Commerce have reported favorably on the bill and no opposition has been made known.

III. COMMITTEE AMENDMENTS

A. Section 2. Excise tax on certain television tubes

Under present law television parts, including tubes, may be sold free of tax for use in the manufacture of any other article. This rule was enacted by Public Law 367, 84th Congress, effective September 1, 1955. Prior to that time, such items could be sold tax free for use in the production only of articles subject to manufacturers' excise tax.

The problem with which this amendment is concerned is liability for manufacturers' excise tax on television tubes purchased for insertion in television tuners in the period October 1, 1952, to August 31, 1955. In an unpublished ruling the Service had held that television tuners were nontaxable articles on

[13] Public Law 87–770, page 86, this Bulletin.

the grounds that they were not "chassis" or any of the other enumerated taxable television components. The Internal Revenue Service so held despite the fact that in a published ruling it had previously held radio tuners to be taxable as "chassis." Some television tuner manufacturers who had not received the private rulings relied on the published ruling and assumed that television tuners were taxable as "chassis" in the same manner as radio tuners and, therefore, that tubes could be purchased tax free for use in their television tuners. Accordingly, they secured exemption certificates from the Internal Revenue Service with respect to their purchases of tubes.

In another unpublished ruling, apparently issued in 1954, the Internal Revenue Service held that tubes purchased by a manufacturer for television tuners lost their identity when inserted in a tuner and that, therefore, when a television set manufacturer purchased a television tuner it represented a nontaxed item even though it contained tubes which had been taxed. This prevented television set manufacturers from claiming a credit when they purchased a television tuner with respect to the tubes contained therein when the television set itself was taxed at the time of its sale. This meant that there was the imposition of a double tax with respect to these television tubes—once when the tube itself was sold to the television tuner manufacturer and again when the television set containing the tuner and tubes was sold by the set manufacturer.

On the basis of these unpublished rulings, of which taxpayers generally cannot be assumed to have knowledge, to the effect that television tuners were not taxable items and that tubes when incorporated in such tuners, even though themselves taxed, were considered to be part of a nontaxed item, the Internal Revenue Service now seeks to collect tax from the television tuner manufacturers with respect to the tubes. Your committee believes that this is inappropriate, both because this results in the imposition of a double tax with respect to these tubes, once with respect to the tubes themselves and a second time with respect to the set including the tuner and the tubes, and also because television tuner manufacturers generally could not be expected to know that the Service considered television tuners to be a nontaxable item. Actually, it was not until 1958 that the Internal Revenue Service, long after the law had been changed by Public Law 367, published a ruling specifying that television tuners were nontaxable articles because they did not perform a "detection or demodulation function" which radio tuners did perform (Rev. Rul. 58–27, 1958–1 CB 414).

This amendment provides, for the period October 1, 1952, through August 31, 1955 (Public Law 367, 84th Cong., became effective September 1, 1955), that articles such as television tuners containing taxable tubes where the article was primarily adapted for use as a component of a television set, was not itself a taxable radio or television component or chassis and was sold for use to a television set manufacturer, the article is to be treated as having been taxed under the tax on radio and television sets, components, etc. By treating the tuner as a taxable component part of a television set, your committee's amendment validates the tax-free purchase of television tubes by the tuner manufacturer. Since the television set manufacturer paid the full tax on its sets at the time of their sale, one full tax will be collected with respect to these tubes. This precludes double taxation and the unjust enrichment of the Government in such cases.

B. Section 3. Local advertising in the form of magazine and outdoor advertising

Under existing law in determining the manufacturers' sales price for the various excise taxes, there is excluded from the base to which these excise tax rates apply certain amounts where the manufacturer makes a separate charge for local or cooperative advertising of the taxable article or reimburses the retailer or other distributor for part of or all of his expenses for local advertising of the taxable articles. Under present law the amount so excluded may not exceed 5 percent of the sales price of the article (excluding the local advertising charges), must be separately stated when the article is sold, and must be intended as a reimbursement of the retailer or other distributor for costs incurred for local advertising. Under existing law the local advertising expenses which may be excluded must meet three tests. First, it must be initiated or obtained by the retailer or other distributor. Second, the advertising must name the article in question and state the location at which it may be purchased at retail. Third, the advertising must consist of a broadcast over a radio station or television station or appear in a newspaper.

Your committee's amendment is concerned with this third feature of the definition of local advertising; namely, types of advertising eligible for this exclusion

from the sales price. The attention of your committee has been directed to the fact that restricting eligible local advertising to radio or television broadcasts or newspaper advertisements discriminates against other forms of advertising frequently carried on jointly by a manufacturer and the retailer or other distributor. Therefore, your committee's amendment expands the media qualifying for the cooperative advertising exclusion to also include advertisements in magazines and advertising which is displayed by means of an outdoor advertising sign or poster. This latter category includes advertising on billboards, whether they are placed on land or affixed to buildings. The other two requirements within the definition of local advertising (i.e., initiation or obtaining by the retailer or other distributor, and the requirement that the article be named and the location at which it may be purchased at retail specified) will apply to magazine and outdoor advertising in the same manner and to the same extent as they presently apply to advertising by the other media. Similarly, the limitation to 5 percent, the requirement of the separate charge and the intention to reimburse the retailer or other distributor for the local advertising apply to the new forms of advertising qualifying to the same extent as the forms of advertising qualifying under existing law.

This amendment is to apply with respect to articles sold on or after the first day of the first calendar quarter beginning more than 20 days after the enactment of this provision.

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[H.R. 6682] [14]

FOWLING NETS—EXCISE TAX ON CERTAIN TELEVISION TUBES—LOCAL ADVERTISING

[Conference Report No. 2412, Eighty-seventh Congress, Second Session]

[September 18, 1962]

Mr. Miles, from the committee of conference, submitted the following conference report to accompany H.R. 6682.

The committee of conference on the disagreeing votes of the two Houses on the amendments of the Senate to the bill (H.R. 6682) to provide for the exemption of fowling nets from duty, having met, after full and free conference, have agreed to recommend and do recommend to their respective Houses as follows:

That the Senate recede from its amendment numbered 1.

Amendment Numbered 2.

That the House recede from its disagreement to the amendment of the Senate numbered 2, and agree to the same with an amendment as follows:

Page 2, line 15, of the Senate engrossed amendments, strike out "Sec. 3." and insert *Sec. 2.;* and the Senate agree to the same.

That the House recede from its disagreement to the amendment of the Senate to the title of the bill and agree to the same.

W. D. Mills,
Cecil R. King,
Thos. J. O'Brien,
Noah Mason,
John W. Byrnes,
Managers on the Part of the House.

Harry F. Byrd,
Robt. S. Kerr,
Russell Long,
By R. S. K.
John J. Williams,
Frank Carlson,
Managers on the Part of the Senate.

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[14] Public Law 87–770, page 86, this Bulletin.

STATEMENT OF THE MANAGERS ON THE PART OF THE HOUSE

The managers on the part of the House at the conference on the disagreeing votes of the two Houses on the amendments of the Senate to the bill (H.R. 6682) to provide for the exemption of fowling nets from duty, submit the following statement in explanation of the effect of the action agreed upon by the conferees and recommended in the accompanying conference report:

Amendment No. 1: This amendment added a new section to the bill relating to the application of the manufacturers excise tax on radio and television components to certain tubes sold during the period beginning October 1, 1952, and ending August 31, 1955. The effect of the amendment would be to exempt the tubes from tax if sold to the manufacturer or producer of an article which (1) was primarily adapted for use as a component part of a television receiving set, (2) was not a taxable chassis or radio and television component, and (3) was sold to a manufacturer or producer of taxable television receiving sets. The Senate recedes.

Amendment No. 2: This amendment added a new section to the bill relating to the definition of the term "local advertising" for purposes of determining the amount excluded from the selling price on which the manufacturers excise tax is based. Under existing law, the term "local advertising" means only advertising which—

(A) is initiated or obtained by the purchaser or any subsequent vendee,

(B) names the article for which the price is determinable under this section and states the location at which such article may be purchased at retail, and

(C) is broadcast over a radio station or television station or appears in a newspaper.

Under the Senate amendment, the term includes advertising which appears in a magazine or is displayed by means of an outdoor advertising sign or poster as well as advertising which appears in a newspaper or is broadcast over a radio station or television station. The House recedes with a clerical amendment.

The House recedes from its disagreement to the amendment of the Senate to the title of the bill.

W. D. Mills,
Cecil R. King,
Thos. J. O'Brien,
Noah Mason,
John W. Byrnes,
Managers on the Part of the House.

[H.R. 12180] [15]

HOUSEHOLD EFFECTS—MONOFILAMENT GILL FISH NETS—ACCIDENT AND HEALTH INSURANCE CONTRACT PREMIUMS

[Senate Report No. 1720, Eighty-seventh Congress, Second Session, Calendar No. 1679]

[July 11, 1962]

Mr. Byrd of Virginia, from the Committee on Finance, submitted the following report to accompany H.R. 12180.

The Committee on Finance, to whom was referred the bill (H.R. 12180) to extend for a temporary period the existing provisions of the law relating to the free importation of personal and household effects brought into the United States under Government orders, having considered the same, report favorably thereon with amendments and recommend that the bill, as amended, do pass.

[15] Public Law 87–790, page 88, this Bulletin.

PURPOSE OF THE BILL

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2. Accident and health insurance contract premiums

Under present law life insurance companies are entitled to a special deduction of 2 percent of premiums attributable to group and accident and health contracts and group life insurance contracts for purposes of the phase 2 tax on underwriting income. The committee has modified present law to provide that individual accident and health contracts written by life insurance companies also will qualify for the special 2-percent deduction unless they are of the nonparticipating type and are issued or renewed for periods of 5 years or more, in which case present law already allows a deduction of 10 percent of the increase in reserves from nonparticipating contracts or, if greater, 3 percent of premiums attributable to nonparticipating contracts (other than group).

This amendment will be of special benefit to smaller life insurance companies which generally do not write substantial group accident and health contracts but which are active in the individual accident and health insurance market, where risks frequently are greater.

Your committee has also extended this special 2-percent deduction in computing underwriting income to casualty insurance companies writing accident and health contracts. This amendment will eliminate whatever advantages the special deduction has given life insurance companies in selling this type of policy in competition with casualty companies. This amendment does not apply to mutual casualty insurance companies since under present law they are not taxable on their underwriting income and your committee does not believe their investment income should be reduced by a deduction clearly associated with their underwriting accounts.

This amendment will apply to taxable years beginning after December 31, 1962.

This amendment is a modified version of the bill, S. 397, on which the Committee on Finance held public hearings on July 6, 1961. It is identical to a committee-approved amendment to the bill, H.R. 4317, which was subsequently passed by the Senate on September 1, 1961, but was lost in conference.

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[H.R. 12180] [16]

HOUSEHOLD EFFECTS—MONOFILAMENT GILL FISH NETS—ACCIDENT AND HEALTH INSURANCE CONTRACT PREMIUMS

[Conference Report No. 2413, Eighty-seventh Congress, Second Session]

[September 18, 1962]

Mr. MILLS, from the committee of conference, submitted the following Conference Report to accompany H.R. 12180.

The committee of conference on the disagreeing votes of the two Houses on the amendments of the Senate to the bill (H.R. 12180) to extend for a temporary period the existing provisions of law relating to the free importation of personal and household effects brought into the United States under Government orders, having met, after full and free conference, have agreed to recommend and do recommend to their respective Houses as follows:

Amendment numbered 1:

That the House recede from its disagreement to the amendment of the Senate numbered 1, and agree to the same with an amendment as follows:

On page 1, line 5, of the Senate engrossed amendments, strike out "1828" and insert *1829;* and the Senate agree to the same.

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[16] Public Law 87–790, page 88, this Bulletin.

Amendment numbered 2:

That the House recede from its disagreement to the amendment of the Senate numbered 2, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following:

SEC. *3. (a) Section 809(d)(6) of the Internal Revenue Code of 1954 (relating to deduction for group life, accident, and health insurance) is amended—*

(1) by striking out "group life insurance contracts and group accident and health insurance contracts" and inserting in lieu thereof "accident and health insurance contracts (other than those to which paragraph (5) applies) and group life insurance contracts"; and

(2) by striking out the heading and inserting in lieu thereof

"(6) CERTAIN ACCIDENT AND HEALTH INSURANCE AND GROUP LIFE INSURANCE.—"

(b) Section 815(e)(2)(C) of such Code (relating to policyholders surplus account) is amended by striking out "group life and group accident and health insurance contracts" and inserting in lieu thereof "accident and health insurance and group life insurance contracts".

(c) The amendments made by this section shall apply to taxable years beginning after December 31, 1962.

And the Senate agree to the same.

That the House recede from its disagreement to the amendment of the Senate to the title of the bill and agree to the same.

W. D. MILLS,
CECIL R. KING,
THOS. J. O'BRIEN,
JOHN W. BYRNES,
HOWARD H. BAKER,
Managers on the Part of the House.
HARRY F. BYRD,
ROBT. S. KERR,
RUSSELL LONG,
By R. S. K.
JOHN J. WILLIAMS,
FRANK CARLSON,
Managers on the Part of the Senate.

STATEMENT OF THE MANAGERS ON THE PART OF THE HOUSE

The managers on the part of the House at the conference on the disagreeing votes of the two Houses on the amendments of the Senate to the bill (H.R. 12180) to extend for a temporary period the existing provisions of law relating to the free importation of personal and household effects brought into the United States under Government orders, submit the following statement in explanation of the effect of the action agreed upon by the conferees and recommended in the accompanying conference report:

Amendment No. 1: This amendment adds a new section to the bill to permit duty-free entry of monofilament gill nets for use in fish sampling, under such rules and regulations as the Secretary of the Treasury may prescribe. The amendment is to apply to articles entered or withdrawn from warehouse for consumption on and after the day following the date of the enactment of the bill. The House recedes with a clerical amendment.

Amendment No. 2: This amendment adds a new section to the bill relating to accident and health insurance contract premiums. Under existing law, in computing gain or loss from operations, life insurance companies are entitled to a special deduction of 2 percent of the premiums for the taxable year attributable to group accident and health insurance contracts. Senate amendment No. 2 extended the deduction to premiums attributable to individual accident and health insurance contracts (other than individual nonparticipating contracts which are issued or renewed for periods of 5 years or more or which are noncancelable contracts for which there are life insurance reserves). The amendment also provided a special 2-percent deduction with respect to both group and individual accident and health insurance contracts for computing underwriting income of casualty insurance companies.

Under the conference agreement, the House recedes with an amendment which (in effect) retains the provisions of the Senate amendment relating to life insurance companies and omits the provisions relating to casualty insurance companies. The extension of the 2-percent deduction to the individual accident and health contracts of life insurance companies was agreed to by the committee of conference in recognition of the competitive situation existing in the case of those companies not in a position to write group contracts. It recognizes, however, that the problem of how broad the application of this deduction should be is a matter which requires further review and consideration. On the one hand, questions have been raised as to whether a deduction for accident and health contracts is desirable in the case of life insurance companies, whether the contracts are group contracts or individual contracts. On the other hand, it is recognized that if this deduction is retained in the case of life insurance companies, the Congress may want to consider the desirability of making a similar allowance in the case of casualty insurance companies. The committee of conference has requested the Treasury Department to report to the Ways and Means and Finance Committees on these problems at the next session of the Congress.

The House recedes from its disagreement to the amendment of the Senate to the title of the bill.

W. D. Mills,
Cecil R. King,
Thos. J. O'Brien,
John W. Byrnes,
Howard H. Baker,
Managers on the Part of the House.

[H.R. 10][17]

SELF-EMPLOYED INDIVIDUALS TAX RETIREMENT ACT OF 1961 [1962][18]

[House of Representatives Report No. 378, Eighty-seventh Congress, First Session, Union Calendar No. 139]

[May 9, 1961]

MR. KEOGH, from the Committee on Ways and Means, submitted the following report to accompany H.R. 10.

The Committee on Ways and Means, to whom was referred the bill (H.R. 10) to encourage the establishment of voluntary pension plans by self-employed individuals, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The committee amendments are technical amendments which appear in the bill, as reported, in line type and in italic type.

I. SUMMARY OF BILL

Your committee's bill is designed to encourage the establishment of voluntary retirement plans by self-employed persons by extending to such plans, and to self-employed individuals covered thereunder, many of the favorable tax benefits present law now provides in the case of qualified retirement plans established by employers for their employees. To accomplish this purpose, self-employed persons are treated for retirement plan purposes as the employers of themselves. As employers, as with other employers, they are permitted to deduct contributions (within specified limits) made to pension or profit-sharing plans for the benefit of themselves, and such other employees as may be covered under the plan. As employees, as with other employees, they are not taxed on such contributions made for their benefit, or the income thereon, until they receive the funds upon retirement or otherwise. Benefits for the self-employed individual may not, under the bill, begin before age 59½ (except in case of early disability or death) nor later than age 70½. The retirement income

[17] Public Law 87-792, page 89, this Bulletin.
[18] Enacted, October 10, 1962, as the "Self-Employed Individuals Tax Retirement Act of 1962."

credit will apply to retirement benefits distributed to self-employed individuals.

By treating self-employed individuals as employees under retirement plans there are brought into play (although with material modification) most of the statutory and administrative rules presently applicable to such plans. The bill establishes special rules to govern retirement plans which cover self-employed individuals who own more than a 10-percent interest in their business (designated in the bill as owner-employees). Self-employed individuals who do not own more than a 10-percent interest in the business are treated in general as are all other employees.

Generally, a self-employed person who owns more than a 10-percent interest in his business is allowed under this bill to contribute to a retirement plan for himself and, if he has three or fewer employees, to deduct from his gross income, up to 10 percent of his self-employment earnings or $2,500, whichever is smaller, each year. If he has more than three employees the ratio of contributions to his self-employment earnings must not exceed the ratio of contributions to wages of any of his employees; otherwise, there is no limitation. However, contributions for such employees must be nonforfeitable at the time they are made. Also, if he has more than three employees the plan may not exclude any employee (other than part-time, seasonal, and temporary employees) who has at least 3 years of service.

The retirement fund which this bill allows self-employed persons to establish must be lodged with a bank as trustee (or as custodian if contributions are invested in stock of a regulated investment company); it may be invested in annuities with an insurance company or in face amount certificates; or it may be placed in a new series of U.S. Government bonds described in the bill. These new bonds will be nontransferable, nonredeemable before retirement, and issued only in the names of individuals. They are intended to provide a convenient and simple form of investment for retirement funds.

More than 7 million self-employed persons who pay income taxes can establish retirement plans under this bill. Because self-employed persons generally have only a limited number of employees, their retirement plans will ordinarily be much smaller in scope than most of the corporate plans already in existence. These new small retirement plans would, if present law rules were not supplemented, also offer somewhat greater opportunities for abuse than do large corporate plans. For this reason, tighter rules for these retirement plans are believed to be necessary.

II. Reasons for the Bill

The primary reason for the bill is to give self-employed persons access to retirement plans on a reasonably similar basis to that accorded corporate stockholder employees. It thus corrects a discrimination in present law under which self-employed individuals and partners are prevented from participating in retirement plans established for the benefit of their employees although owner-managers of corporations may do so.

In 1959 the Treasury Department recognized that present law did not give self-employed persons tax treatment for their retirement savings comparable to that accorded to employees covered by em-

ployer-financed pension plans. In 1960 the Treasury Department submitted an approach to the retirement problem of self-employed persons which was different from earlier legislative proposals. In effect the approach submitted by the Treasury Department would have granted self-employed individuals tax treatment comparable to that received by employees now covered by qualified pension plans by permitting them to participate in pension plans in much the same manner as employees. This approach, however, would have imposed additional restrictions on the participation of self-employed persons in qualified pension plans and would have imposed similar restrictions on the participation of corporate-owner managers in such plans. To the extent that this bill, as approved by your committee, treats self-employed individuals as employees for the purpose of permitting them to participate in qualified pension plans it adopts the proposal that had been submitted by the Treasury. In view of the revenue loss involved, the omission of other parts of the previously submitted Treasury approach, and the relationship to the general aspects of tax reform, the present Treasury Department has expressed the view that this problem should be considered as part of next year's broad-based tax reform.

The bill seeks to encourage self-employed persons to establish voluntary plans in order to make some provision for their own retirement. However, if the self-employed person has more than three employees, the bill requires provision for the retirement needs of each of them who has more than 3 years' service, if the self-employed person is to make deductible contributions on his own behalf. Moreover, inasmuch as a self-employed individual always has a vested right to contributions he makes for himself, your committee believes it is only fair to require that employees be granted similar vested rights. Thus, if there are more than three employees, contributions for them must be fully vested at the time they are made.

Your committee has provided these additional requirements in the case of plans covering self-employed persons with more than three employees because such plans more closely resemble existing pension plans than do those which cover a self-employed person with three or fewer employees. In the latter case, it is not uncommon for employees to leave the employ of self-employed persons after only a short period of service. For example, in many cases receptionists, stenographers, and other employees often plan to work for only a few years, after which they may marry and leave their employment. It would be difficult both from the self-employed person's standpoint and from the standpoint of the Internal Revenue Service to oversee the operation of countless small plans covering long-departed employees whose whereabouts may be unknown. This difficulty is only partially offset by a 3-year service requirement for coverage of employees. Thus, your committee's bill does not require a self-employed person with three or fewer employees to establish a pension plan covering them. On the other hand, the bill does not discourage or prevent such a self-employed individual from including his employees under a pension plan if he desires to do so. To the contrary, your committee believes many a self-employed person with three or fewer employees would desire to cover his employees under a pension plan if he could make deductible contributions for himself. In this respect,

your committee's bill should encourage the establishment of such plans, thus broadening the scope of employee pension plan coverage.

The bill allows contributions to retirement plans to be a deduction for income tax purposes at the time these contributions are made, but requires that retirement benefits when received be subject to taxation. The bill thus allows deferment of tax on certain forms of savings set aside for retirement, but limits the amount of these retirement savings of self-employed persons which are so treated. Since the self-employed person is viewed as both an employer and as an employee, this deferral is consistent with present law, under which employers are permitted to deduct contributions to qualified pension plans for their employees, while employees are not required to include in their incomes such contributions, or the income thereon, until they are received as benefits under the plan.

Your committee is of the opinion that extending the coverage of individuals under voluntary retirement plans is in the public interest, and that self-employed persons should have the opportunity to obtain retirement benefits on substantially the same basis as do corporate owner-managers. The bill will make self-employment somewhat more attractive than at present compared to employment with a corporation, and will thus help to keep small business strong and independent professional practice thriving.

Under the bill there are some differences between rules covering retirement plans which include self-employed individuals and rules covering employee pension plans. These rules are considered necessary because of the unique characteristic of self-employment. Generally, the special rules require that owner-employees having more than three employees give them greater vested rights than they might obtain under the pension plan of a corporation. The special rules in the case of owner-employees with three or fewer employees generally impose rigid restrictions on amounts of contributions which are made tax deductible.

III. Present Law

Present law accords favorable tax treatment to pension and profit-sharing plans established for the exclusive benefit of employees or their beneficiaries. Employees covered under qualified plans are not taxed currently on contributions made on their behalf to these plans by their employers nor on the income from amounts so contributed. Instead, the employees generally include the benefits from such plans in taxable income only in the year they are received or made available.

The deferment of tax on retirement benefits until ultimate distribution applies whether or not the employee has vested (non-forfeitable) rights in the contributions made on his behalf. Typically, under corporate plans the employee does not have immediate vested rights to all such contributions, although plans vary considerably; they range from immediate vesting to vesting after reaching a certain number of years of service or attaining a specified age, or upon actual retirement.

The income of trusts established to administer qualified pension plans is exempt from income tax. Similarly, the Life Insurance Company Income Tax Act of 1959 granted exemption, fully effective in 1961, to income on insurance reserves established in connection with qualified pension plans. In addition, under present law, em-

ployers are permitted to take tax deductions (within specified limits) for their contributions to qualified plans. The law grants this favored tax treatment only to retirement plans which do not discriminate as to coverage, contributions, or benefits in favor of employees who are stockholders, officers, or supervisors, or employees who are highly compensated.

A qualified retirement plan cannot provide a higher rate of contribution or benefit for higher paid employees than for lower paid employees, or for shareholder employees than for those who are not shareholders. However, the dollar amount of benefits or contributions for the higher paid employees may be larger than for the lower paid employees, provided that such amounts constitute a uniform percentage of the compensation of participants.

Under appropriate circumstances, the private plan may be integrated with the social security system; if thus integrated, the proportion of social security benefits not attributable to the employee's own contributions is taken into consideration in determining whether the benefits paid by the private plan meet the nondiscrimination test. Under the law and administrative rules the benefits of the higher paid employees, after being combined with a designated portion of social security benefits, must not be larger in relation to salary than the similarly combined benefits of lower paid employees.

Under existing law more than 50,000 corporate pension plans have been established. These plans cover nearly 20 million employees and have, at the present time, somewhat more than $40 billion in assets. Corporations contribute more than $4 billion per year to qualified retirement plans.

IV. Revenue Effect

The revenue loss under your committee's bill is estimated to range from $325 to $358 million in a typical full year of operation. This estimate of revenue loss assumes that not all of the self-employed persons in various groups will establish pension plans, and that only part of the maximum allowable deduction will be taken in many cases. The percentage of maximum allowable deduction assumed to be taken ranges from 15 percent for the group of self-employed individuals with incomes of less than $3,000 to 66⅔ percent for those with incomes of over $20,000. Since the provisions of the bill would be applicable to taxable years beginning after December 31, 1961, and since many taxpayers who will ultimately avail themselves of the program will not do so immediately, the revenue loss for fiscal year 1962 is estimated at $125 million.

V. Effective Date

The provisions of this bill are made applicable to taxable years beginning after December 31, 1961.

VI. General Explanation of Bill

A. SELF-EMPLOYED PERSONS AS OWNER-EMPLOYEES

The bill provides a series of special requirements for qualification of retirement plans which cover self-employed individuals (sole proprietors and partners) having more than a 10-percent interest in the business with respect to which the plan is established. Under the bill, such self-employed individuals are characterized as "owner-employees." However, in some situations, the bill imposes restrictions upon all self-employed persons regardless of their percentage of ownership. (For example, denial of capital gains treatment on lump-sum distribution and the denial of the estate and gift tax exclusions.) Partners who do not own more than 10 percent of their business also are permitted to participate in pension plans, but because they are not owner-employees plans covering them will, in general, be governed by the nondiscriminatory rules of present law, except where the bill imposes additional restrictions upon self-employed individuals generally.

B. SELF-EMPLOYED RETIREMENT PLANS

Subject to limitations, your committee's bill would allow self-employed individuals (including partners) to be covered in qualified retirement plans. This would permit self-employed individuals to secure the benefits of current tax deductions, plus a tax-free buildup of pension fund investments, by establishing a plan which meets the requirements of the Internal Revenue Code. The bill treats plans covering self-employed persons under new rules established for that purpose. If the self-employed person is an owner-employee, the requirements applicable to a plan covering him will depend upon whether he has more than three employees.

Plans covering owner-employees with more than three employees.—In the case of an owner-employee with more than three employees, the plan must provide retirement benefits for all employees (except part-time and seasonal employees) who have more than 3 year's service and contributions for such employees must be vested at the time they are made. Although the present law provides that some employees may be excluded from pension plan coverage on the basis of a "reasonable classification," your committee believes it desirable to require an owner-employee with more than three employees to cover all of his employees except seasonal, temporary, and part-time workers, and full-time employees who have less than 3 years of service. With these exceptions employees must be covered whether they are salaried employees or wage earners, and whether or not they work in different departments or enterprises. Under present law, retirement plans can exclude employees with up to 5 years of service. Moreover, under the bill, as approved by your committee, rules applicable to plans covering an owner-employee with more than three employees will continue to apply, even after the number of employees drops below four. Thus, these rules, once applicable, will be permanent.

Plans covering owner-employees with three or fewer employees.—In the case of owner-employees with three or fewer employees, the bill does not require coverage of those employees. However, those employees may, as under existing law, be covered under a qualified pension plan if the owner-employee desires to provide retirement benefits for them. If they are covered, the plan, or the portion of the plan, covering em-

ployees must not discriminate between those employees, and there must be no discrimination as between owner-employees. But as between employees, on the one hand, and owner-employees, on the other, the nondiscrimination rules will not apply.

It is not required that contributions on behalf of employees of such an owner-employee be vested when they are made, but under a new requirement of the bill, made applicable to retirement plans generally, contributions or benefits for employees must be vested upon termination of the plan or upon complete discontinuance of contributions under the plan.

C. SELF-EMPLOYMENT EARNINGS

The measuring rod for deductible contributions for self-employed persons is "self-employment earnings." Under your committee's bill, a proprietor or partner may be covered under a qualified retirement plan if he has such earnings. For purposes of this bill such earnings are defined generally to mean net earnings from self-employment as in section 1402(a); that is, the net income "derived by an individual from any trade or business carried on" by him or by the partnership of which he is a member. This definition includes persons who have net earnings from self-employment even though they do not pay a self-employment tax, for example, because they also have wages (as employees of another business) of at least $4,800. Such a person is permitted to participate in an owner-employee plan even though contributions also are being made for him under a qualified plan of his employer. Moreover, the bill also permits doctors and ministers, as well as certain persons who work in their own homes, and commission salesmen (other than full-time life insurance salesmen who are treated under present law as employees for pension purposes) to participate even though they do not have net earnings from self-employment within the meaning of the Internal Revenue Code.

D. LIMITATIONS ON DEDUCTIBLE CONTRIBUTIONS FOR SELF-EMPLOYED

The bill restricts the amount of deductible contributions which may be made by or for an owner-employee covered by a plan.

Owner-employee with more than three employees.—If the owner-employee has more than three employees, in order for him to make any contribution for his own retirement needs he must cover all his employees who have more than 3 years' service. Moreover, he must give each of them nonforfeitable rights to contributions made for them at the time such contributions are made. Having made these provisions for his employees, such an owner-employee under the bill is permitted to contribute and deduct for himself up to the same proportion of his covered income as the plan requires to be contributed for employees. Contributions for the owner-employee with more than three employees are not restricted by the 10-percent $2,500 limitation on deductible contributions for an owner-employee with more than three employees. For application of this limitation to a plan coordinated with social security, see section F.

A real estate broker with four full-time employees earns $30,000 in a certain year from commission selling. All employees have more than 3 years' service. Two of the employees earn $4,000 each; the other two earn $10,000 each. The plan calls for nonforfeitable con-

tributions for each employee who has more than 3 years' service of 20 percent of his earnings. Thus, for his employees, the owner-employee would contribute, and deduct, $5,600 (20 percent of $28,000). And, for himself, he would be permitted to contribute, and deduct, the same proportion of his self-employment earnings, $6,000 (20 percent of $30,000).

Owner-employee with three or fewer employees.—If an owner-employee has three or fewer employees, he may contribute to a qualified pension plan and deduct up to 10 percent of his self-employment earnings, or $2,500, whichever is the lesser. He may provide pension plan coverage for his employees under the nondiscriminatory rules of existing law, if he so desires. If he covers his employees in a pension plan it is not required that contributions for himself be related to contributions for his employees, but as between the employees contributions and benefits must be nondiscriminatory.

The following examples illustrate the application of the limitations of the bill on deductible contributions which may be made by a self-employed individual with three or fewer employees.

> Example 1: A lawyer has self-employment earnings of $30,000. He has no employees. He may contribute, and deduct, $2,500 (the lesser of $2,500 or 10 percent of $30,000).
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> Example 2: A physician, whose self-employment earnings amount to $25,000, has three employees, each of whom he pays $5,000. He establishes a retirement plan covering both himself and his employees. The plan calls for contributions of 10 percent of self-employment earnings for him and 8 percent of salary for the employees. Contributions for the employees are forfeitable at the time they are made. The plan is a qualified plan under the bill and the amount deductible is $3,700 ($2,500 for himself (10 percent of $25,000) and $1,200 for his employees (3 times $5,000 times 8 percent)).

E. VESTED BENEFITS

The bill, as approved by your committee, adds new requirements to the statute relating to vesting of benefits or contributions made for employees.

Owner-employee with more than three employees.—In the case of owner-employees with more than three employees, contributions for employees with more than 3 years service under a plan must be nonforfeitable at the time they are made. This requirement is made a condition governing the qualification of a plan covering such owner-employees, and unless a provision for vesting is included in the terms of the plan contributions for owner-employees would not be deductible.

Owner-employee with three or fewer employees.—There is no corresponding requirement for vested employee benefits in the case of owner-employees with three or fewer employees. If such owner-employees choose to provide retirement plans for their employees, the plan may provide forfeitable benefits or it may provide for vesting. However, if there is a plan covering employees of such an owner-employee, the bill elsewhere provides (in connection with all retirement plans, including plans provided by corporations) that upon termination or complete discontinuance of contributions under a plan amounts credited to an employee's account must be nonfor-

feitable. This new provision adds to the statute a requirement which has been in the Treasury regulations for many years. Thus, while there is no requirement for immediate vesting, the bill precludes the possibility that contributions for employees which have been deducted for income-tax purposes may revert back to the employer, or owner-employee. This requirement should serve to prevent abuses resulting from termination of plans.

F. INTEGRATION WITH SOCIAL SECURITY

Under your committee's bill, retirement plans covering owner-employees may be integrated, or coordinated with social security under special rules provided by the bill. Under such integration or coordination, the overall cost of a retirement plan might be materially reduced. The present integration rules assume that the employer has paid for that portion of the social security benefit for which the employee himself has not paid.

Owner-employee with more than three employees.—If an owner-employee with more than three employees establishes a retirement plan which meets the prescribed requirements as to coverage and vesting, and if deductible contributions for owner-employees are not more than one-third of the total contributions made under the plan, owner-employees, if they take into account self-employment taxes paid on their own behalf, may also take into account the employer portion of the FICA tax paid on behalf of covered employees. The method of coordinating such pension plan and social security payments under your committee's bill is different from the method permitted by Treasury rulings under the provisions of present law. Under this bill the owner-employee is given credit only for the amount of social security taxes actually paid by him for his employees. The following example illustrates the application of this rule.

A and B, equal partners in a contracting business, have six employees, each of whom has more than 3 years' service. A retirement plan is established under which employees with more than 3 years' service will be given immediate nonforfeitable rights to contributions made on their behalf. The plan calls for contributions of 15 percent of gross salary for covered employees, and of 15 percent of self-employment earnings for owner-employees, with provision for coordinating the plan with social security. Salaries of employees and self-employment earnings of the partners appear in the following schedule, along with other pertinent information.

	Earnings	Total earnings or wages	15 percent of earnings or wages	Total self-employment tax (4½ percent of $4,800) and FICA tax paid by employer (3 percent of up to $4,800)	Contribution under integrated plan
2 partners	[1] $7,500	$15,000	$2,250	$432	$1,818
4 employees	[1] 6,000	24,000	3,600	576	3,024
1 employee	5,000	5,000	750	144	606
1 employee	4,000	4,000	600	120	480
Total partners		15,000	2,250	432	1,818
Total employees		33,000	4,950	840	4,110
Total partners and employees		48,000	7,200	1,272	5,928

[1] Each.

Thus, since contributions for owner-employees, after coordination with social security ($1,818), do not exceed one-third of deductible contributions under the plan ($5,928), social security and self-employment taxes may be taken into account. After coordination, $5,928 must be contributed under the plan, of which $1,818 is attributable to owner-employees and $4,110 is attributable to employees, as shown in the schedule.

Owner-employee with three or fewer employees.—Owner-employees with three or fewer employees are not required by the bill to provide retirement plan coverage for their employees unless they choose to do so. If they provide such a plan for their employees, the plan, or the portion of the plan relating to employees, may be coordinated with social security under the rules of existing law.

G. METHODS OF FUNDING

Trusteed plans and employee annuity plans.—As under present law, qualified retirement plans covering self-employed individuals or self-employed individuals and their employees may be funded either through contributions to a trust or by purchase of annuity contracts (including variable annuity contracts) directly from an insurance company. Self-employed individuals establishing such plans for themselves, or for themselves and their employees, could, if they chose to do so, use associations to pool their separate funds for investment purposes.

Custodial accounts.—In addition, your committee's bill permits the use of a custodial account, in lieu of a trust, if its investments are made solely in a regulated investment company which issues only redeemable stock. Although a custodial account may be utilized by a retirement plan, whether or not it includes an owner-employee, it will be particularly beneficial to small owner-employee-type plans because of its lesser costs. Such lesser costs result from the fact that the bank would not be required to assume the duties and responsibilities of a trustee, but would serve only as a mere custodian of amounts contributed under retirement plans.

Face amount certificates.—Your committee has also made it plain that retirement funds may be invested directly in nontransferable face-amount certificates, which would be treated for retirement plan purposes as annuities. Such certificates may presently be purchased by a trusteed plan under existing law, but not under nontrusteed annuity plans. Your committee's bill makes it clear that such certificates may in the future be purchased in the same manner as annuities.

Bond purchase plan.—A completely new form of retirement plan involving direct investment in a new series of Government bonds is authorized by your committee's bill. The principal features of the bond purchase plan are explained in section J of this report.

H. CONTRIBUTORY PLANS

Owner-employee with more than three employees.—Under the bill, contributory retirement plans permitting or requiring contributions by employees, as well as those to which the employer alone makes contributions, may be established by an owner-employee with more than three employees. If employees who are not owner-employees are permitted to make nondeductible contributions to the plan, such an

owner-employee also may make nondeductible contributions on his own behalf up to 10 percent of his self-employment earnings or $2,500, whichever is the lesser; however, the rate of such contributions must not exceed the rate permitted for employees. Such contributions will not be deductible either by the employee or the owner-employee, but must be made out of income that has already been taxed. The making of such nondeductible contributions are beneficial, however, because the income earned thereon will not be taxed until it is received from the fund, upon retirement or otherwise.

Owner-employee with three or fewer employees.—Owner-employees with three or fewer employees are not permitted to make nondeductible contributions for themselves, although the plan might permit employees who are covered (if any) to make nondeductible contributions on their own behalf. Consequently, they may establish such a plan for their employees if they so desire.

I. PROFIT-SHARING PLANS

Your committee's bill does not limit participation of self-employed individuals to fixed contribution pension plans. Rather, it also permits them to participate in profit-sharing plans paying retirement benefits, under which contributions may be made in profitable years but there would be no obligation to make contributions in years of little or no profit. To avoid the abuse of making larger or smaller contributions in years when surtax rates are lower or higher, a definite formula for determining the amount of contributions to be made on behalf of employees who are not owner-employees appears to be necessary. Consequently, in order for an owner-employee to participate in such a plan, it must provide such a definite formula.

J. BOND PURCHASE PLANS

As an alternative form of investment which will be of particular interest to new pension plans established by small businesses, direct investment in U.S. Government securities of a new series is authorized. These new bonds, which must be issued in the names of the individual employees (including owner-employees) on whose behalf they are purchased (and thus will be nonforfeitable), will be nontransferable and may not be cashed until the individual in whose name the bonds are issued has attained age 59½ (insurance age 60) or has become disabled or deceased. In order to prevent these bonds from being used for purposes other than retirement, the bill provides that interest on them must stop no later than 5 years after the death of the bond owner. This period corresponds generally to other provisions of the bill requiring distribution of a deceased owner-employee's interest in a retirement plan within a specified period after his death. The purpose of direct bond purchases under a qualified retirement plan is to avoid the expense of establishing a trust to administer the retirement fund assets. The new series of Government securities may also be purchased by the trustee of an existing pension plan if it is desired to make that form of investment. Where a pension plan has invested in these retirement bonds, the bill provides that no income will be realized by the employee at the time the bonds are distributed to him; rather the principal and interest on the bonds will be included in the employee's income at the time they are re-

deemed. Although these new bonds may be purchased by anyone, their cost will be deductible for income tax purposes only if they are purchased under a qualified bond purchase plan or by a qualified retirement plan. The amount deductible is to be determined in the same manner as if the cost of the bond were a contribution to a qualified retirement trust, except that the special rules relating to excess contributions in the case of owner-employee type plans do not apply. Those rules are considered inappropriate to qualified bond purchase plans not only because the special bonds might be purchased by anyone (and not solely for retirement purposes), but also because the denominations in which the bonds might be issued will not necessatily bear any relation to the amount which might be deducted by an owner-employee. Under the bond purchase plan approved by your committee, income realized on the redemption of the special bonds will always be taxed at ordinary rates. Moreover, there would be no capital gains treatment on a lump-sum distribution of these special bonds to an individual covered by a qualified pension trust. By making the earliest redemption date for these bonds age 59½, except in the case of death or disablity, these bonds will generally be unattractive to ordinary investors because they may hesitate to freeze their capital for long periods of time.

K. EXCESS CONTRIBUTIONS

The bill provides certain penalties where excess contributions are made under a pension plan. An excess contribution is an amount greater than the permitted deductible and nondeductible contributions. The bill requires that any such excess contributions must be returned to the person or to the business that made it, together with income earned on the excess contribution. The income so returned will be taxable to the self-employed person for whom the contribution was made. If an excess contribution is not repaid within 6 months after notification has been received that the contribution was excessive, the plan is temporarily disqualified (until the excess is returned) with regard to the person on whose behalf the excess contribution was made and he is taxed on the annual income earned by the entire fund in the plan which is attributable to his interest. Where an excess contribution is willfully made, however, the entire interest of the individual on whose behalf it was made in all plans in which he participated as an owner-employee (including the corpus allocated to his account) is required to be distributed to him, and he is further disqualified from participating in any pension plans as an owner-employee for a 5-year period. Furthermore, no opportunity is given to repay a willful excess contribution and escape the consequences.

L. PAYMENT OF BENEFITS TO OWNER-EMPLOYEES

The bill requires that new retirement plans established by owner-employees for their own benefit, or for the benefit of themselves and their employees, may not begin paying retirement benefits to owner-employees before they reach age 59½ (insurance age 60) except in the event of death or disability. Under your committee's bill an individual is considered disabled if unable to engage in any substantial gainful activity because of a medically determinable physical or mental impairment which can be expected to result in death or to be of long-

continued and indefinite duration. Distributions of retirement benefits, however, must begin not later than 70½ (insurance age 70). If the owner-employee dies, his interest in the retirement plan must be distributed within 5 years from the date of his death or used within 5 years to purchase an immediate annuity for his beneficiary.

M. PREMATURE DISTRIBUTIONS

A penalty is imposed by the bill in cases where a premature distribution of all or part of the retirement fund is made before the owner-employee reaches age 59½. In these cases, if the premature distribution amounts to $2,500 or more, the tax imposed would not be less than 110 percent of the increase in tax that would have resulted if the income had been received ratably over the 5 years ending with the year of distribution. For purposes of this provision, taxable income for any of the taxable years involved is deemed to be not less than the appropriate portion of the distributed amount. If the premature distribution amounts to less than $2,500, the tax due would be 110 percent of the increase in tax resulting from inclusion of the entire amount of the premature distribution in gross income for the current year. In either event, the taxable income for the year in which the distribution occurs is treated as being not less than the excess of the amount of the distribution includible in gross income over the deductions allowable for personal exemptions. Any resulting increase in tax can be reduced only by the credit for withheld taxes. As a further penalty in case of a premature distribution, the owner-employee is disqualified from participating in a retirement plan on his own behalf for 5 years following the year in which the total distribution is made. These penalties are imposed in order to prevent retirement plans from, in effect, becoming income-averaging plans under which deductible contributions would be made to the plan in high-income, high-tax years and the assets would be drawn down in low-income or loss years when little or no tax would be due. It is the purpose of this bill to provide means for financing retirement; these penalties are designed to insure that retirement plans will not be used for other purposes.

N. TWO OR MORE BUSINESSES

An owner-employee (or a group of two or more owner-employees) who controls more than one business would be required under the bill to group together all controlled business activities for the purpose of determining whether contributions for him would be limited by the rules which apply to owner-employees with three or fewer employees or whether he would be governed by rules applicable to owner-employees with more than three employees. An owner-employee may not exceed the limitations on deductible contributions by splitting his activities among two or more businesses and establishing retirement plans in each, nor could he divide his businesses and set up a retirement plan in one business in which, for example, he is the only employee;

O. ANNUITY TREATMENT FOR DISTRIBUTIONS

As under present law, retirement benefits when paid to individuals from qualified plans would be taxable as ordinary income, except to the extent that they have been financed by nondeductible contribu-

tions made under a contributory pension plan, in which case benefits would be taxable under existing rules which allow individuals to recover their capital invested in a retirement contract free of tax.

P. ESTATE AND GIFT TAX EXEMPTION

With respect to the estate and gift tax exemption in the case of retirement plan benefits, your committee's bill does not change present law as it applies to ordinary employees, including owner-managers of corporations. However, the bill does not extend these exemptions to the self-employed (whether or not they are owner-employees) insofar as contributions were made to the plan by or for the individual while he was a self-employed person. The estate and gift tax exclusions will continue to apply with respect to any employer contributions made while the individual was not a self-employed person.

Q. LUMP-SUM DISTRIBUTIONS

While your committee's bill does not extend to self-employed individuals (whether or not they are owner-employees) capital gain treatment on certain lump-sum distributions from retirement plans, such treatment is not denied to employees of the self-employed who are treated in the same manner as employees of corporations. Under the bill, a self-employed individual will receive capital gains treatment on that portion of a lump-sum distribution which is attributable to any employer contributions made on his behalf while he was not a self-employed person. He will not have capital-gain treatment for lump-sum distributions derived from contributions as a self-employed person, but a special averaging device provides for the taxing of such lump-sum distributions received by self-employed individuals after age 59½. Under the bill, the tax he will pay is limited to five times the increase in tax resulting from treating 20 percent of such a lump-sum distribution as taxable income. In this way some protection from the graduated rates of the individual income tax is given to the self-employed individual who receives a lump-sum distribution.

R. PROHIBITED TRANSACTIONS

The bill tightens the prohibited transaction rules of present law with respect to trusts forming part of pension plans covering owner-employees who control the business by means of a more than 50-percent ownership interest. In these situations, since the owner-employee is, in effect, dealing with himself, your committee has provided that the owner-employee may not borrow from a trust he has established, may not buy from or sell property to that trust, and may not charge any fees for services he renders to the trust. It may be extremely difficult to police the large number of small trusts that may be established under this bill, and for this reason the prohibited transactions rules have been tightened.

S. SUMMATION OF REQUIREMENTS FOR OWNER-EMPLOYEE PLANS

In summary, new retirement plans established by self-employed individuals must meet the following requirements or qualifications in addition to those which present law requires of all retirement plans:

(1) If it is a trusteed plan, the trustee must be a bank or similar institution with fiduciary powers, but another person (who may be the employer) may be given power to control investments of the trust fund.

(2) In the case of owner-employees, benefits may not be payable before the owner-employee reaches age 59½, except in the case of severe disability or death, and benefit payments must begin before he reaches age 70½.

(3) In the case of plans of self-employed individuals with more than three employees, contributions for employees must be nonforfeitable at the time they are made.

(4) In the case of a profit sharing plan, a definite formula for determining employee contributions must be provided.

(5) If there are more than three employees contributions for the owner-employee are not permitted to exceed the ratio of contributions for any other employee.

(6) Where a self-employed individual has more than three employees, the plan may be coordinated with social security (under special rules) only if contributions for him are not more than one-third of the total contributions made under the plan.

(7) No excess contribution may be made.

(8) If an owner-employee dies, his entire interest must within 5 years be distributed to designated beneficiaries or used to provide immediate annuities for them.

(9) Excess contributions, if made, must be returned to the person who made them, and income earned by the plan which is attributable to the interest of an owner-employee with respect to whom an excess contribution was not timely returned must be taxed to the owner-employee.

(10) For purposes of qualifying the plan and determining what limitations are applied to contributions for owner-employees, two or more businesses controlled by an owner-employee or by a group of owner-employees must be considered as a single business.

(11) Contributions on behalf of any owner-employee must be determined on the basis of his net earnings from self-employment from the trade or business with respect to which the retirement plan is established.

VII. Provisions of Bill Made Applicable to All Retirement Plans

The bill adds three new paragraphs to section 401(a) of the code; these have the effect of codifying certain regulations and administrative practices of the Internal Revenue Service. These three new paragraphs apply to all pension plans, not merely those which cover owner-employees.

Vesting on termination of plan.—The first of these new paragraphs requires that, upon termination of the plan or complete discontinuance of contributions thereto, the rights of all employees then covered by the plan must be nonforfeitable. This new provision is especially important in connection with new retirement plans established by owner-employees with three or fewer employees. Without such a requirement, it would be possible for such an owner-employee to establish a forfeitable pension plan for his employees, make deductible

contributions, enjoy a tax-free buildup of income on such contributions and subsequently terminate the plan and have the entire amount revert back to him with favorable tax results. This requirement imposes upon owner-employees an obligation, upon termination of a plan, to actually pay out to his employees amounts contributed for them notwithstanding the fact that such contributions were forfeitable when they were made. It thus prevents abuses from developing under purely forfeitable plans.

Time of payment of benefits under a plan.—The second of these new paragraphs makes employee benefits payable not later than the taxable year in which the employee reaches age 70½, or retires, whichever is later. In the case of an employee who is an owner-employee benefits must be payable not later than the taxable year in which he reaches age 70½.

Forfeitures.—The third of these new paragraphs imposed upon all retirement plans makes it plain that forfeitures of nonvested funds must not be used to increase the benefits any employee would otherwise receive under the plan.

VIII. Miscellaneous Provisions of the Bill

The bill permits self-employed individuals to qualify for the retirement-income credit on the basis of distributions from qualified retirement plans. However, it does not permit self-employed persons to qualify either for the $5,000 death-benefit exclusion or for the sick-pay exclusion. Those provisions were enacted for the benefit of employees as contrasted to the self-employed and it is not the purpose of this bill to treat self-employed individuals as employees except for retirement-plan purposes. However, the bill does allow a self-employed individual to exclude from his gross income under section 104 of the code amounts received through accident or health insurance for personal injuries or sickness, to the extent that such amounts are attributable to his own nondeductible contributions.

Where pension contributions take the form of the purchase of annuities, any loans against these contracts are treated as distributions and any repayments of such loans are treated as contributions. In addition, if any portion of a trust or of a contract is assigned or pledged, that portion is also treated as a distribution from the trust or under the plan. Without these rules, an owner-employee could, in effect, obtain premature access to a substantial portion of the pension funds being accumulated for his retirement.

The bill makes it plain that the deduction for contributions made to a retirement plan by a self-employed individual on his own behalf may not be used to increase a net operating loss, and that owners of unincorporated businesses which elect to be taxed as corporations may participate in qualified retirement plans only in their capacity as self-employed persons. The bill also makes it clear that amounts contributed to a qualified retirement plan by a self-employed individual which are deductible, are treated as deductions from gross income in computing adjusted gross income. Thus, a self-employed individual may take this deduction and still qualify for the standard deduction.

Technical Explanation of the Bill

FIRST SECTION. SHORT TITLE

The first section of the bill provides that the act may be cited as the "Self-Employed Individuals Tax Retirement Act of 1961."

SECTION 2. QUALIFICATION OF PLANS

Section 2 of the bill amends section 401 of the Internal Revenue Code of 1954 to provide for the coverage of self-employed individuals under qualified pension and profit-sharing plans. In addition, section 2 amends section 401 to add additional requirements which must be met in order for a trust forming part of a plan covering self-employed individuals who own more than 10 percent of the business to qualify under section 401. There are also added to section 401 certain additional requirements which must be met by all qualified trusts and plans.

Section 401(a)

Existing section 401(a)(5) of the code provides that a plan shall not be considered discriminatory merely because the contributions or benefits under the plan bear a uniform relationship to the "total compensation, or the basic or regular rate of compensation," of the employees covered under the plan. Paragraph (1) of section 2 of the bill amends section 401(a)(5) to provide that, for purposes of this rule, the total compensation of a self-employed individual is such individual's self-employment earnings (as defined in sec. 401(c)(3)), and that the basic or regular rate of compensation of such an individual is that portion of his self-employment earnings which bears the same ratio to his total self-employment earnings as the basic or regular compensation of the employees (other than self-employed individuals) covered under the plan bears to their total compensation. This ratio is to be computed in accordance with regulations prescribed by the Secretary or his delegate.

Existing section 401(a) of the code sets forth the requirements which a pension, profit-sharing, or stock bonus trust must meet in order to constitute a qualified trust. Paragraph (2) of section 2 of the bill adds additional requirements (new pars. (7) to (12), inclusive).

The new paragraph (7) of section 401(a) provides that a trust will not qualify unless the plan of which it is a part provides that, upon its termination or upon complete discontinuance of contributions under the plan, the employees covered under the plan will be granted immediate vested rights with respect to so much of their benefits under the plan as have accrued and have been funded at the time of the termination or discontinuance or, in the case of a money purchase plan, will be granted immediate vested rights to the amounts credited to their account as of the date of the termination or discontinuance. This provision is not to be applicable, however, to benefits or contributions which, pursuant to regulations prescribed by the Secretary or his delegate to preclude discrimination, may not be used for designated employees in the event of early termination of the plan. For example, this provision would not require vesting when certain officers or highly compensated employees are, at the inception of the plan, within a few years of retirement age and the

granting of vested rights to such employees upon termination of the plan shortly after they reach retirement age would result in the plan being discriminatory in favor of such officers or highly compensated employees.

The new paragraph (8) of section 401(a) provides that a trust will not qualify unless, under the plan of which it is a part, the entire interest of each employee either (A) will be distributed to him before the close of his taxable year in which he attains the age of 70½ years, or, in the case of an employee other than an owner-employee (as defined in sec. 401(c)(4)), in which he retires, whichever is the later, or (B) will be distributed, commencing before the close of such taxable year (i) over the life of such employee or over the lives of such employee and his spouse, or (ii) over a period not extending beyond the life expectancy of such employee or the life expectancy of such employee and his spouse. For these purposes, the Secretary or his delegate is to issue regulations prescribing the specific conditions under which these requirements will be considered to be met.

The new paragraph (9) of section 401(a) provides that a trust forming part of a pension plan will not qualify unless the pension plan of which it is a part provides that forfeitures must not be applied to increase the benefits any employee would otherwise receive under the plan. Therefore, if the plan calls for future contributions, the forfeitures must be used to reduce such contributions.

The new paragraphs (10) and (11) of section 401(a) provide the rules relating to the extent to which a plan covering self-employed individuals must satisfy the nondiscrimination requirements in section 401(a). Under paragraph (10), a plan providing for current or future contributions for any owner-employee (i.e., a self-employed individual owning more than 10 percent of the trade or business) must also cover each employee of such trade or business having a period of employment of 3 years or more, if—

(1) on one day in each quarter in the taxable year of the plan, the employer has more than three employees; or

(2) on one day in each quarter in a prior taxable year of the plan, the employer had more than three employees and the new paragraph (10) applied to such plan.

For purposes of determining whether the employer has more than three employees, the new paragraph (10) provides that there shall not be taken into account any employee whose customary employment is for not more than 20 hours in any one week or is for not more than 5 months in any calendar year. In addition, it is provided that there shall not be taken into account, as an employee, any owner-employee. Paragraph (10) also provides that, in determining the period of employment of a partner who is not an owner-employee, the period of time during which he has been such a partner shall be included in his period of employment.

The new paragraph (11) provides that if section 401(a)(10) does not apply and if the plan benefits owner-employees, then the determination as to whether a trust forming part of the plan is a qualified trust is to be made under section 401—

(1) if such plan benefits only owner-employees, without regard to the fact that such plan does not benefit employees other than owner-employees; and

(2) if such plan also benefits employees other than owner-employees—

(A) with respect to the portion of the plan which benefits employees other than owner-employees, without reference to the portion of the plan which benefits owner-employees; and

(B) with respect to the portion of the plan which benefits owner-employees, without reference to the portion of the plan which benefits employees other than owner-employees.

Thus, a sole proprietor, or a partnership, with three or less employees may establish a qualified plan which covers (1) only such proprietor or the partners (excluding any partner who does not own more than 10 percent of either the capital interest or the profits interest in the partnership), (2) only the employees (including any partner who does not own more than a 10-percent interest in the partnership), or (3) both such proprietor or partners and such employees. In the third case, the nondiscrimination requirements must be satisfied as to each portion of the plan.

The new paragraph (12) of section 401(a) provides that a trust forming part of a plan covering a self-employed individual owning more than 10 percent of the business must, in order to qualify under section 401, also meet the new requirements of section 401(d).

Section 401(c)

Paragraph (3) of section 2 of the bill adds a new subsection (c) to section 401(a) of the code, which contains certain definitions relating to self-employed individuals and owner-employees.

(1) *Definition of employee.*—Under the present law, a qualified plan can cover only those individuals who are employees under common law. Paragraph (1) of the new subsection (c) defines the term "employee" to include, for any taxable year, a self-employed individual.

(2) *Definition of self-employed individual.*—Paragraph (2) of the new subsection (c) defines the term "self-employed individual" to mean an individual who has self-employment earnings (as defined in sec. 401(c)(3)) for the taxable year.

(3) *Definition of self-employment earnings.*—Paragraph (3) of the new subsection (c) contains a definition of self-employment earnings. Such term means the net earnings from self-employment (as defined in sec. 1402(a) of the code) determined with certain modifications. The first of these modifications provides that doctors and certain ministers, who are not subject to the tax on self-employment income, shall be treated, for this purpose, as being engaged in a trade or business from which net earnings from self-employment are derived. The second modification provides that certain salesmen described in section 3121(d)(3) of the code who are not employees but who are not subject to the tax on self-employment income shall be similarly treated. The third modification provides that amounts which are not otherwise includible in gross income shall not be included in an individual's net earnings from self-employment.

(4) *Definition of "owner-employee."*—Certain of the provisions of the bill are applicable only to owner-employees or to plans covering owner-employees. Paragraph (4) of the new subsection (c) defines the term "owner-employee" to mean a self-employed individual who—

(A) derives self-employment earnings from a trade or business carried on by him, or

(B) in the case of a partnership, is a partner who owns more than 10 percent of either the capital interest or the profits interest in such partnership.

(5) *Definition of "employer."*—In order to qualify under section 401, a plan must be a plan of an employer. Paragraph (5) of the new subsection (c) provides that, for this purpose, a self-employed individual who carries on a trade or business shall be treated as his own employer. Similarly, a partnership shall be treated as the employer of its partners who are self-employed individuals.

Section 401(d)

Paragraph (3) of section 2 of the bill also adds a new subsection (d) to section 401, which sets forth additional requirements which must be met in order for a trust forming part of a pension or profit-sharing plan covering owner-employees to qualify under section 401.

(1) *Trustee must be a bank.*—Paragraph (1) of the new subsection (d) provides that, in the case of a trust which is created on or after the date of the enactment of the bill, or which was created before such date but is not exempt as a qualified trust on the day before such date, the trustee must be a bank. However, paragraph (1) provides that a person (including the employer) other than a bank may be granted, under the trust instrument, the power to direct the investment of the trust funds. Paragraph (1) is not applicable to a trust created or organized outside the United States before the date of the enactment of the bill if, under section 402(c), such trust is treated as exempt from taxation under section 501(a) on the day before such date. Such paragraph (1) defines the term "bank" to mean (A) a bank as defined in section 581, and (B) a corporation which under the laws of the State of its incorporation is subject to supervision and examination by the Commissioner of Banking or similar officer, and (C) in the case of a foreign trust, a bank or trust company, wherever incorporated, exercising fiduciary powers and subject to supervision and examination by governmental authority.

(2) *Time of distribution.*—Paragraph (2) of the new subsection (d) provides that, under the plan, no benefits may be paid to any owner-employee prior to his attaining age 59½, except in the case of his disability (within the meaning of sec. 213(g)(3) of the code).

(3) *Vesting.*—Paragraph (3) of the new subsection (d) provides that, in the case of a plan to which section 401(a)(10) applies (i.e., a plan of an employer with more than three employees which covers one or more owner-employees), the employees' rights to or derived from the contributions under the plan must be nonforfeitable at the time such contributions are paid to or under the plan.

(4) *Definite contribution formula.*—Paragraph (4) of the new subsection (d) provides that a profit-sharing plan covering an owner-employee must provide a definite formula for determining contributions to be made to the trust by the employer on behalf of employees (other than owner-employees). Because of the limitations in section 404 on the amount that may be deducted for contributions on behalf of an owner-employee, the plan need not provide a definite formula for determining the contributions to be made on behalf of owner-employees.

(5) *Ratio of contributions; coordination with social security.*—Paragraph (5) of the new subsection (d) provides that a plan, to which section 401(a)(10) applies, may not permit a ratio of employer con-

tributions to compensation, in the case of an owner-employee, to exceed the ratio of employer contributions to compensation, in the case of other employees. Such paragraph (5) provides that the term "compensation" means total compensation, or basic or regular rate of compensation, whichever may be specified in the plan. In the case of a self-employed individual, the terms "total compensation" and "basic or regular rate of compensation" have the meaning assigned to them in section 401(a)(5). For purposes of determining whether the contributions by the employer meet the prescribed ratio, paragraph (5)(B) of the new subsection (d) provides that taxes paid under section 3111 (relating to tax on employers) with respect to an employee may be taken into account as contributions by the employer for such employee under the plan, if—

(A) of the contributions deductible under section 404 for the taxable year, not more than one-third is deductible by reason of contributions by the employer for owner-employees; and

(B) taxes paid by the owner-employees under chapter 2 (relating to tax on self-employment income), and the taxes which would be payable under such chapter 2 by the owner-employees but for paragraphs (4) and (5) of section 1402(c), are taken into account as contributions by the employer for such owner-employees.

(6) *Excess contributions.*—Paragraph (6) of the new subsection (d) provides that the plan must not permit—

(A) contributions to be made by an employer for any owner-employee in excess of the amounts which may be deducted under section 404 for the taxable year;

(B) in the case of a plan (or, if sec. 401(a)(11) applies, the portion of a plan) which covers only owner-employees, contributions to be made in excess of those which are deductible under section 404 for the taxable year; and

(C) if a distribution under the plan is made to any owner-employee before such owner-employee attains the age of 59½ or becomes disabled, contributions to be made on behalf of such owner-employee for the 5 taxable years succeeding the taxable year in which such distribution is made.

(7) *Distributions after death.*—Under paragraph (7) of the new subsection (d), the plan must provide that, after the death of an owner-employee, his interest in the plan must be either distributed to his beneficiary within 5 years or used within that period to purchase an immediate annuity for his beneficiary.

(8) *Repayment of excess contributions.*—Paragraph (8) of the new subsection (d) provides that, under the plan—

(A) any excess contribution (as defined in sec. 401(e)(1)), together with the income attributable thereto, is (except in the case of a willfully made excess contribution) to be repaid to the owner-employee by or for whom such excess contribution was made;

(B) if for any taxable year the plan does not, by reason of section 401(e)(2)(A), meet (for purposes of sec. 404) the requirements of section 401(d) with respect to an owner-employee, the income for the taxable year attributable to the interest of such owner-employee under the plan is to be paid to such owner-employee; and

(C) the entire interest of an owner-employee is to be repaid to him when required by section 401(e)(2)(E) (relating to willful excess contributions).

(9) *More than one trade or business.*—Paragraph (9)(A) of the new subsection (d) provides that, if the plan covers an owner-employee who controls, or two or more owner-employees who together control, the trade or business with respect to which the plan is established, and who also control as an owner-employee or as owner-employees one or more other trades or businesses, such plan and the plans (if any) established by such other trades or businesses must constitute an overall plan which meets the nondiscrimination requirements of section 401(a) (3) and (4), to the extent required by the new paragraph (10) or (11) of section 401(a), with respect to the employees of all such trades or businesses. In determining whether section 401(a) (10) or (11) applies, the employees of all the trades or business shall be taken into account.

Paragraph (9)(B) of the new subsection (d) provides that an owner-employee, or two or more owner-employees, shall be considered to control a trade or business if such owner-employee, or such two or more owner-employees together—

(i) own the entire interest in an unincorporated trade or business, or

(ii) in the case of a partnership, own more than 50 percent of either the capital interest or the profits interest in such partnership.

For purposes of determining his ownership interest, an owner-employee, or two or more owner-employees, shall be treated as owning any interest in a partnership which is owned, directly or indirectly, by a partnership which such owner-employee, or such two or more owner-employees, are considered to control within the meaning of paragraph (9)(B).

(10) *Contributions limited to the self-employment earnings from the trade or business.*—Paragraph (10) of the new subsection (d) provides that, under the plan, contributions on behalf of any owner-employee may be made only with respect to self-employment earnings of such owner-employee derived from the trade or business with respect to which the plan is established.

Section 401(e)

Paragraph (3) of section 2 of the bill also adds a new subsection (e) to section 401, which contains a definition of "excess contribution" and which sets forth the consequences of making such an excess contribution.

(1) *Definition of "excess contribution."*—Paragraph (1) of the new subsection (e) defines the term "excess contribution" to mean—

(A) if, in the taxable year, contributions are made under the plan only by or for owner-employees, of if the plan is one to which section 401(a)(11) applies, so much of any contribution made by or for any owner-employee as is not deductible under section 404 for the taxable year; or

(B) if, in the taxable year, contributions are made under the plan on behalf of both owner-employees and other employees and section 401(a)(11) does not apply to such plan—

(i) so much of any contribution made by an employer for any owner-employee as (without regard to the new subsec-

tion (e)) is not deductible under section 404 for the taxable year;

(ii) so much of any contribution as is made by an owner-employee (as an employee) at a rate which exceeds the rate of contributions permitted to be made by employees other than owner-employees; and

(iii) so much of any contribution made by an owner-employee (as an employee) as exceeds the lesser of $2,500 or 10 percent of his self-employment earnings for such taxable year derived by such owner-employee from the trade or business (or trades or businesses) with respect to which the plan is established; and

(C) any contribution made by or for an owner-employee in any taxable year for which, under section 401(e)(2) (A) or (E), the plan does not (for purposes of sec. 404) meet the requirements of section 401(d) with respect to such owner-employee.

Such paragraph (1) provides, however, that the amount of any contribution which is allocable (determined in accordance with regulations prescribed by the Secretary of the Treasury or his delegate) to the purchase of life, accident, health, or other insurance shall not be taken into account in determining the amount of any contribution for purposes of determining whether such contribution is an excess contribution.

(2) *Effect of excess contribution.*—Paragraph (2)(A) of the new subsection (e) provides that, if an excess contribution (other than a willful excess contribution to which sec. 401(e)(2)(E) applies) is made by or for an owner-employee in any taxable year, the plan with respect to which such excess contribution is made shall, except as provided in section 401(e)(2) (C) and (D), be considered, for purposes of section 404, as not meeting the requirements of section 401(d) with respect to such owner-employee for the taxable year and for all succeeding taxable years. In any year when an otherwise exempt trust forming part of a plan is (pursuant to par. (2)(A)) considered, for purposes of section 404, as not meeting the requirements of section 401(d) with respect to an owner-employee, the earnings of such trust (including those attributable to the interest of the owner-employee with respect to whom the excess contribution was made) shall remain exempt from tax in the hands of the trust. However, the trust shall not be considered exempt for purposes of deducting any contributions made by or for the owner-employee with respect to whom the excess contribution was made.

Paragraph (2)(B) of the new subsection (e) provides that, for any taxable year for which a plan does not meet the requirements of section 401(d) with respect to an owner-employee by reason of paragraph (2)(A), such owner-employee shall currently include in his gross income the income for such year attributable to his interest in the plan.

Paragraph (2)(C) of the new subsection (e) provides that paragraph (2)(A) (and, consequently, paragraph (2)(B)) shall not apply to an excess contribution with respect to any taxable year if (on or before the close of the 6-month period beginning on the day on which the Secretary or his delegate sends by certified or registered mail, to the trust, insurance company, or other person to whom such excess contribution was paid, notice of the amount of such excess contribution) the amount of such excess contribution, and the income attributable

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thereto, is repaid to the owner-employee by or for whom such excess contribution was made. Such paragraph (2)(C) further provides that, if the contribution is an excess contribution by reason of exceeding the deduction limitations under section 404, the notice required to be sent by the Secretary or his delegate shall not be mailed prior to the time that the amount of the tax under chapter 1 of the Internal Revenue Code of the owner-employee to whom the excess contribution is to be repaid has been finally determined for the taxable year in which such excess contribution was made.

Paragraph (2)(D) of the new subsection (e) provides that, if an excess contribution, together with the income attributable thereto, is not repaid within the 6-month period, paragraph (2)(A) shall not apply to any taxable year beginning with the taxable year in which the trust, insurance company, or other person to whom such excess contribution was paid repays the amount of such excess contribution to the owner-employee by or for whom such excess contribution was made, and also pays to such owner-employee the amount of income attributable to the interest of such owner-employee which, under paragraph (2)(B), has been included in such owner-employee's gross income for any prior taxable year.

(3) *Special rule if excess contribution was willfully made.*—Paragraph (2)(E) of the new subsection (e) provides that, if an excess contribution made by or for an owner-employee is determined to have been willfully made, then, instead of applying the provisions of section 401(e)(2) (A), (B), (C), and (D)—

(i) there shall be distributed to the owner-employee by or for whom such excess contribution was willfully made his entire interest in all plans in which he is a participant as an owner-employee; and

(ii) contributions may not be made by or for such owner-employee to any plan in which he is a participant as an owner-employee for the taxable year in which it is determined that such excess contribution was willfully made and for the 5 taxable years following such taxable year.

Thus, when it has been determined that an excess contribution has been willfully made to a plan by or for an owner-employee, such owner-employee's entire interest in all plans in which he is a participant as an owner-employee must be distributed to him and he may not participate in any plan with respect to which he is an owner-employee for the taxable year of the determination and for the 5 succeeding taxable years.

(4) *Statute of limitations.*—Paragraph (2)(F) of the new subsection (e) provides that, in any case in which a plan does not meet the requirements of section 401(d) with respect to an owner-employee by reason of paragraph (2)(A), the period for assessing any deficiency arising by reason of—

(i) the disallowance of any deduction under section 404 because such plan does not meet the requirements of section 401(d) with respect to an owner-employee by or for whom an excess contribution was made, or

(ii) the inclusion, under paragraph (2)(B), in gross income of such owner-employee of the income attributable to his interest under a plan

for the taxable year in which such excess contribution was made or for any succeeding taxable year shall not expire prior to 1 year after the close of the 6-month period referred to in paragraph (2)(C).

Section 401(f)

Under present law, section 401(a) of the code relates only to trusts which form part of pension, profit-sharing, and stock-bonus plans. Paragraph (3) of section 2 of the bill also adds a new subsection (f) to section 401, which permits certain custodial accounts to qualify under section 401(a) if they form a part of qualified plans. Under the new subsection (f), a custodial account shall be treated as a qualified trust, if—

(1) such custodial account satisfies all the requirements which must be satisfied by a qualified trust;

(2) the custodian is a bank (as defined in section 581);

(3) the investment of the funds in such account (including all earnings) is to be made solely in regulated investment company stock with respect to which an employee is the beneficial owner (treating as subject to this requirement all capital gain dividends and any refund to the custodian under section 852(b)(3)(D)(ii) of the code); and

(4) the custodian or its nominee is the shareholder of record of all stock held in the account.

For purposes of the code, in the case of a custodial account treated as a qualified trust under section 401 by reason of the new section 401(f), the custodian of such account is to be treated as the trustee thereof.

Paragraph (2) of the new subsection (f) defines "regulated investment company" to mean a domestic corporation (A) which is a regulated investment company within the meaning of section 851(a), and (B) which issues only redeemable stock.

Section 401(g)

Under present law, there are certain provisions applicable to annuity contracts purchased by a qualified trust or under a qualified nontrusteed plan. Paragraph (3) of section 2 of the bill also adds a new subsection (g) to section 401 which provides that, for purposes of sections 401, 402, 403, and 404, the term "annuity" includes a face-amount certificate, as defined in section 2(a)(15) of the Investment Company Act of 1940 (15 U.S.C., sec. 80a–2), which is nontransferable.

SECTION 3. DEDUCTIBILITY OF CONTRIBUTIONS TO PLANS

Section 3 of the bill amends section 404 of the Internal Revenue Code of 1954 to allow the deduction of contributions made by or for self-employed individuals who are covered under qualified plans. In addition, section 404 is amended to provide limitations on the amount that may be deducted with respect to contributions by or for self-employed individuals who are owner-employees.

Section 404(a)

(1) *Annuity plans.*—Section 404(a)(2) allows, within the applicable limitations, the deduction of employer contributions paid toward the purchase of retirement annuities if such purchase is a part of a plan which meets the requirements of section 401(a) (3), (4), (5), and (6),

and if certain other conditions are met. Subsection (a)(1) of section 3 of the bill amends section 404(a)(2) to provide that the annuity plan must, in addition to meeting the present requirements, also meet the requirements in the new paragraphs (7), (8), (9), and (10) or (11) of section 401(a) and, if the plan covers owner-employees, the requirements of the new section 401(d) (2), (3), (5), (6), (7), (8), (9), and (10). Thus, a qualified annuity plan is, in general, subject to the same requirements as is a qualified pension, profit-sharing, or stock-bonus plan.

(2) *Inclusion of self-employed.*—Subsection (a)(2) of section 3 of the bill adds a new paragraph (8) to section 404(a), which allows the deduction under section 404(a) of contributions to a qualified plan covering self-employed individuals. To accomplish this purpose, the new paragraph (8) provides that, for purposes of applying section 404 to a qualified pension, annuity, or profit-sharing plan covering self-employed individuals—

(A) the term "employee" is defined to include a self-employed individual within the meaning of section 401(c)(2), and the employer of such a self-employed individual is defined to mean the person treated as his employer under section 401(c)(5);

(B) the term "self-employment earnings" has the meaning assigned to it by section 401(c)(3);

(C) the contributions to such a plan by or for a self-employed individual shall be considered to satisfy the conditions of section 162 or section 212 to the extent that such contributions do not exceed the self-employment earnings of such individual derived from the trade or business with respect to which such plan is established. However, contributions by or for self-employed individuals which are allocable (determined in accordance with regulations prescribed by the Secretary or his delegate) to the purchase of life, accident, health, or other insurance are not considered to satisfy the conditions of section 162 or section 212 and, therefore, are not deductible under section 404; and

(D) all references in section 404 to the term "compensation" shall, in the case of a self-employed individual, be considered a reference to the self-employment earnings such individual derived from the trade or business with respect to which the plan is established.

(3) *Plans covering owner-employees.*—Subsection (a)(2) of section 3 of the bill also adds a new paragraph (9) to section 404(a), which provides special rules for computing the limitations on the amounts deductible for contributions under a qualified pension, annuity, or profit-sharing plan covering owner-employees.

Subparagraph (A) of the new paragraph (9) provides that the limitations in paragraphs (1), (2), (3), and (7) of section 404 (a) shall be computed, with respect to employees (other than owner-employees), as if such employees were the only employees covered under the plan. For example, if a qualified profit-sharing plan covers both owner-employees and other employees, the amount deductible under section 404(a)(3) with respect to contributions on behalf of such other employees is 15 percent of the compensation paid to such other employees if there are no carryovers for such year.

Subparagraph (B) of the new paragraph (9) provides that the limitations in paragraphs (1), (2), (3), and (7) of section 404(a), with

respect to contributions under a qualified plan on behalf of owner-employees, shall be computed —

(i) as if such owner-employees are the only employees covered under the plan; and

(ii) without regard to the carryover provisions contained in section 404(a)(1)(D), the second and third sentences of section 404(a)(3), and the second sentence of section 404(a)(7).

Subparagraph (C) of the new paragraph (9) provides that the amounts which are otherwise deductible under section 404(a) with respect to contributions by or for an owner-employee shall not exceed the additional limitations provided in section 404(e).

The new paragraph (9) further provides that, for purposes of section 404, the term "owner-employee" has the meaning assigned to it by section 401(c)(4).

Section 404(e)

Subsection (b) of section 3 of the bill adds to section 404 a new subsection (e), which provides additional limitations on amounts which may be deducted with respect to contributions on behalf of owner-employees.

(1) *Special limitations for owner-employees.*—Paragraph (1) of the new subsection (e) provides the additional limitations which are applicable in determining the amount that may be deducted with respect to contributions under a qualified plan on behalf of owner-employees. Under paragraph (1), the amounts deductible under section 404(a) in any taxable year with respect to contributions on behalf of such owner-employees shall not exceed—

(A) except as provided in section 404(e)(1)(B), $2,500, or 10 percent of the self-employment earnings derived by such owner-employee from the trade or business with respect to which the plan is established, whichever is the lesser; or

(B) in the case of a plan to which section 401(a)(10) applies, the maximum amount of contributions permitted to be made on behalf of such owner-employee under section 401(d)(5).

(2) *Overall limitation.*—Paragraph (2) of the new subsection (e) provides that in any taxable year in which amounts are deductible under two or more plans (whether established with respect to the same trade or business or different trades or businesses) on behalf of an individual who is an owner-employee with respect to such plans, the aggregate amount deductible for such taxable year under such plans with respect to contributions on behalf of such owner-employee shall not exceed whichever of the following amounts is the greater:

(i) $2,500, or

(ii) the sum of the amounts so contributed under all such plans to which section 401(a)(10) applies to the extent that, with respect to each such plan, the amount contributed does not exceed the amount described in section 404(e)(1)(B).

The overall limitation in paragraph (2) has no application with respect to contributions made under a plan on behalf of an employee who is not an owner-employee of the trade or business with respect to which the plan is established, even though such employee may be covered as an owner-employee under a plan or plans established by other trades or businesses.

Paragraph (2)(B) of the new subsection (e) provides that, in any case when paragraph (2)(A) reduces the amounts which are otherwise deductible under section 404 with respect to contributions made on behalf of an owner-employee under two or more plans, the portion of such reduced amount which is deductible under each plan shall be determined in accordance with regulations prescribed by the Secretary or his delegate.

(3) *Contribution allocable to insurance protection.*—Paragraph (3) of the new subsection (e) provides that the special limitations in section 404(e) are not applicable with respect to contributions which are allocable (determined under regulations prescribed by the Secretary or his delegate) to the purchase of life, accident, health, or other insurance.

Section 404(f)

Subsection (b) of section 3 of the bill also adds to section 404 a new subsection (f), which provides that, for purposes of section 404, any amount paid, directly or indirectly, by an owner-employee in repayment of any loan on an insurance policy which, under section 72 (m)(4)(B), was treated as an amount received under a contract, shall be treated as a contribution to which section 404 (including the limitations therein) applies on behalf of such owner-employee.

SECTION 4. TAXABILITY OF DISTRIBUTIONS

Section 4 of the bill amends section 72 of the Internal Revenue Code of 1954 to provide rules for the taxation of amounts distributed under qualified plans to self-employed individuals or the beneficiaries of such individuals.

Section 72(d)

Existing section 72(d) of the code provides a special rule for the taxation of an annuity receivable by an employee when the aggregate amount receivable by the employee under the terms of the contract during the 3-year period beginning on the date on which the amount is first received under the contract as an annuity is equal to or greater than the consideration for the contract contributed by the employee. Subsection (a) of section 4 of the bill amends section 72(d)(2) to provide that, for purposes of section 72(d) any contribution which is made with respect to the contract while the employee is a self-employed individual and which is not allowed as a deduction under section 404 shall be treated as consideration for the contract contributed by the employee. This amendment merely makes clear that, as in the case of qualified plans established by corporations, a self-employed individual may not treat as consideration for the contract contributed by the employee any contributions under the plan for which deductions were allowed and which, consequently, are considered employer contributions. Moreover, under the new section 72(m)(2), contributions on behalf of a self-employed individual which are used to purchase life, accident, health, or other insurance are not, for purposes of section 72(d), included in the employee's basis for the contract.

Section 72(m)

Subsection (b) of section 4 of the bill adds to section 72 a new subsection (m), which provides special rules applicable to the taxation of employee annuities and distributions under employee plans.

(1) *Amounts received before annuity starting date.*—Paragraph (1) of the new subsection (m) provides that any amounts which are received under an annuity, endowment, or life insurance contract before the annuity starting date and which are not received as an annuity (within the meaning of sec. 72(e)(2)) shall be included in the recipient's gross income for the taxable year in which received to the extent that—

(A) such amounts, plus amounts theretofore received under the contract and includible in gross income under such paragraph (1), do not exceed

(B) the aggregate premiums or other consideration paid for the contract on behalf of an employee while such employee was an owner-employee (as defined in sec. 401(c)(4)) which were allowed as deductions under section 404 for the taxable year and all prior taxable years. For this purpose, the aggregate premiums or other consideration paid for the contract does not include any portion of such premiums or other consideration which is properly allocable (as determined under regulations prescribed by the Secretary or his delegate) to the cost of life, accident, health, or other insurance.

Such paragraph (1) further provides that any amounts received under an annuity, endowment, or life insurance contract before the annuity starting date which are not received as an annuity and which are not includible in gross income under such paragraph (1) shall be subject to the provisions of section 72(e).

The provisions of paragraph (1) may be illustrated by the example of a self-employed individual who receives $8,000 as a distribution under a qualified pension plan before the annuity starting date. At the time of such distribution, $10,000 had been contributed and deducted under the plan on behalf of such individual while he was not an owner-employee and $5,000 had been contributed and deducted under the plan on his behalf while he was an owner-employee. In addition, such individual had contributed $2,000 on his own behalf under the plan. Of the $8,000, $5,000 (the amount contributed and deducted on behalf of the individual while he was an owner-employee) is includible in gross income under paragraph (1). Of the remaining $3,000, $1,000 (the amount in excess of the individual's contributions on his own behalf) is includible in gross income under section 72(e).

(2) *Computation of consideration paid by a self-employed individual.*—Paragraph (2) of the new subsection (m) provides that in computing—

(A) the aggregate amount of premiums or other consideration paid for the contract for purposes of section 72(c)(1)(A),

(B) the consideration for the contract contributed by the employee for purposes of section 72(d)(1), and

(C) the aggregate premiums or other consideration paid for purposes of section 72(e)(1)(B),

any amount allowed as a deduction with respect to the contract under section 404 while the employee was a self-employed individual shall be treated as consideration contributed by the employer. Such paragraph (2) further provides that the amounts described in paragraph (2) (A), (B), and (C) shall not include any portion of the premiums or other consideration for the contract paid while the employee was an owner-employee which is allocable (as determined under regula-

tions prescribed by the Secretary of the Treasury or his delegate) to the cost of life, accident, health, or other insurance.

Paragraph (2) merely makes it clear that there shall not be included in an employee's, or in his beneficiary's, basis for a contract any amount which was contributed by such employee under a qualified plan and which was allowed as a deduction under section 404. In addition, under paragraph (2), there shall not be included in the basis of any contract the amount of any premiums or other consideration paid to purchase for an employee while he was an owner-employee any life, accident, health, or other insurance. Present law is to be applied in determining whether an amount to which paragraph (2) does not apply should be included in the basis of a contract.

(3) *Life insurance contracts.*—Paragraph (3) of the new subsection (m) is applicable to any life insurance contract—

(i) which is purchased as part of a qualified annuity plan described in section 403(a), or

(ii) which is purchased by a qualified trust, if the proceeds of such life insurance contract are payable directly or indirectly to a participant in such trust or to a beneficiary of such participant.

Paragraph (3)(B) provides that any contributions to such a qualified annuity plan or such a qualified trust allowed as a deduction under section 404, and any income of such a qualified trust, which are determined (in accordance with regulations prescribed by the Secretary or his delegate) to have been applied to purchase the life insurance protection under a life insurance contract to which paragraph (3) applies are includible in the gross income of the employee for whom such protection is purchased for the taxable year when such contributions, or such income, are so applied. In the case of the death of an employee insured under a life insurance contract to which paragraph (3) applies, an amount equal to the cash surrender value of such contract immediately before the death of the employee shall be treated as a payment under the qualified plan or trust, and the excess of the amount payable by reason of the death of the insured over such cash surrender value shall not be includible in gross income under section 72 and shall be treated as provided in section 101. The provisions of paragraph (3) are rules presently contained in the regulations under the Internal Revenue Code of 1954.

(4) *Amounts constructively received.*—Paragraph (4)(A) of the new subsection (m) provides that, if during any taxable year an owner-employee assigns (or agrees to assign) or pledges (or agrees to pledge) any portion of his interest in a qualified trust or any portion of the value of a contract purchased as part of a qualified annuity plan, such portion shall be treated as having been received in such taxable year by such owner-employee as a distribution from such trust or as an amount received under such contract. Paragraph (4)(B) provides that, if during any taxable year an owner-employee receives, directly or indirectly, any amount from an insurance company as a loan under a contract purchased by a qualified trust or purchased as a part of a qualified annuity plan, and issued by such insurance company, the amount of such loan is to be treated as an amount received under the insurance contract in such taxable year.

(5) *Penalties applicable to certain amounts received by owner-employees.*—Paragraph (5) of the new subsection (m) provides a penalty tax on certain amounts received by an owner-employee under a

qualified trust or annuity plan. Paragraph (5)(A) provides that the penalty tax is applicable—

(i) to amounts (other than any amount received by an individual in his capacity as a policyholder of an annuity, endowment, or life insurance contract which is in the nature of a dividend or similar distribution) which are received under a qualified pension, annuity, or profit-sharing plan by an individual, who is, or has been, an owner-employee, before such individual attains the age of 59½, for any reason other than the individual's becoming disabled (within the meaning of sec. 213(g)(3) of the code), but only to the extent that such amounts are attributable to the contributions paid on behalf of such individual (whether or not paid by him) while he was an owner-employee;

(ii) to amounts which are received under such a qualified plan at any time by an individual who is, or has been, an owner-employee, or by the successor of such individual, but only to the extent that such amounts are determined, under regulations prescribed by the Secretary or his delegate, to exceed the benefits provided for such individual under the plan formula; and

(iii) to amounts which are received by reason of the distribution under the provisions of section 401(e)(2)(E) (relating to willfully made excess contributions) by an individual who is, or has been, an owner-employee of his entire interest in all such qualified plans.

The penalty tax is applicable to such amounts even though, at the time they are received, the recipient is not an owner-employee. In the case of an early distribution described in paragraph (5)(A)(i), the penalty tax is applicable to only so much of the distribution as is attributable to contributions paid on behalf of the recipient while he was an owner-employee. However, the penalty tax is applicable to the entire amount, to the extent it exceeds the benefits under the plan formula, received by an employee (or by the successor of an employee) who is, or has been, an owner-employee, even though a portion of such amount may be attributable to contributions made on behalf of such employee while he was not an owner-employee.

Paragraph (5)(B) provides that, if the aggregate of the amounts to which the penalty tax is applicable received by any person in his taxable year equals or exceeds $2,500, the increase in his tax for that taxable year attributable to the receipt of such amounts shall not be less than 110 percent of the aggregate increase in taxes, for that taxable year and the four immediately preceding taxable years, which would have resulted if such amounts had been included in such person's gross income ratably over such taxable years. If deductions had been allowed under section 404 for contributions paid on behalf of such person while he is an owner-employee for a number of prior taxable years less than four, paragraph (5)(B)(i) shall be applied by taking into account the number of taxable years immediately preceding the taxable year in which the amount was so received equal to such lesser number.

Under paragraph (5)(C), if the aggregate of the amounts to which the penalty tax is applicable received by a person in his taxable year is less than $2,500, the increase in tax attributable to the receipt of such amounts shall be 110 percent of the increase computed without regard to this penalty tax.

Paragraph (5)(D) provides that the penalty tax shall not apply to any amount which is taxed, under section 402(a)(2) or section 403(a)(2), at capital gains rates. On the other hand, since a distribution required as a result of a determination that a willful excess contribution has been made on behalf of an owner-employee is not a distribution on account of separation from service or death, the penalty tax will, in all cases, be applicable to such a distribution.

Paragraph (5)(E) provides that section 72(n)(3) is to be applied for purposes of computing the taxable income for taxable years to which paragraph (5) applies.

Paragraph (6) of the new subsection (m) provides that, for purposes of section 72, the term "owner-employee" has the meaning assigned to it by section 401(c)(4).

Section 72(n)

Subsection (b) of section 4 of the bill also adds to section 72 a new subsection (n), which provides special tax treatment with respect to certain total distributions received under a qualified plan.

(1) Paragraph (1) of the new subsection (n) sets forth the distributions to which the special tax treatment in section 72(n) applies. In the case of a qualified pension or profit-sharing trust, the special tax treatment is applicable to amounts distributed to a distributee, if such amounts represent the total distributions payable to the distributee with respect to an employee and if such amounts are paid to the distributee within 1 taxable year of the distributee—

(i) on account of the employee's death,

(ii) after the employee has attained the age of 59½ years, or

(iii) after the employee has become disabled (within the meaning of sec. 213(g)(3) of the code).

In the case of a qualified annuity plan, the special tax treatment is applicable to amounts paid to a payee, if such amounts represent the total amounts payable to the payee with respect to an employee and if such amounts are paid to the payee within 1 taxable year of the payee—

(i) on account of the employee's death,

(ii) after the employee has attained the age of 59½ years, or

(iii) after the employee has become disabled (within the meaning of sec. 213(g)(3)).

For the special tax treatment to be applicable to a distributee or payee with respect to a distribution of an employee's interest in a qualified plan, it is not necessary that there also be distributed within the 1-year period any portion of the employee's interest which is payable to another payee or distributee.

The special tax treatment provided by the new section 72(n) is, under paragraph (1)(C), applicable only with respect to so much of any distribution or payment as is attributable to contributions made under a qualified plan by or for a self-employed individual. If an employee receives a distribution or payment of his own interest in a qualified plan or trust, the special tax treatment is applicable to such distribution or payment only if contributions which were allowed as a deduction under section 404 have been made by or for such employee while he was a self-employed individual for five or more taxable years prior to the taxable year in which such distribution is paid. In addition, the special tax treatment is not applicable to amounts to which the penalty tax in section 72(m)(5) is applicable.

(2) Paragraph (2) of the new subsection (n) provides that, in any case when the special tax treatment applies, the tax attributable to the amounts to which the new subsection (n) applies for the taxable year for which such amounts are received is not to exceed whichever of the following is the greater:

(A) five times the increase in tax which would result from the inclusion in gross income of the recipient of 20 percent of so much of the amount so received as is includible in gross income; or

(B) five times the increase in tax which would result if the taxable income of the recipient for such taxable year equaled 20 percent of the amount of the taxable income of the recipient for such taxable year determined under section 72(n)(3)(A).

(3) Paragraph (3) of the new subsection (n) provides that (notwithstanding sec. 63) for purposes only of computing the tax under chapter 1 of the Internal Revenue Code of 1954 attributable to amounts to which the new subsection (n) or section 72(m)(5) (relating to the penalty tax in the case of certain distributions) applies and which are includible in gross income—

(A) the taxable income of the recipient for the taxable year of receipt is to be treated as being not less than the amount by which (i) the aggregate of such amounts so includible in gross income exceeds (ii) the amount of the deductions allowed for such taxable year under section 151 (relating to deductions for personal exemptions); and

(B) in making ratable inclusion computations under paragraph (5)(B) of section 72(m), the taxable income of the recipient for any taxable year involved in such ratable inclusion is to be treated as being not less than the amount required by such paragraph (5)(B) to be treated as includible in gross income for such taxable year.

In any case in which section 72(n)(3) results in an increase in taxable income for any taxable year, the resulting increase in the taxes imposed by section 1 or section 3 for such taxable year shall not be reduced by any credit under part IV of subchapter A of chapter 1 (other than sec. 31) of the Internal Revenue Code of 1954 which, but for this provision, would be allowable. Under paragraph (3), in no case is there subjected to tax under the penalty tax in section 72(m)(5) or the special tax treatment in section 72(n) amounts which represent a recipient's basis in the distribution.

The application of the rules in paragraph (3) of the new subsection (n) in the case of a total distribution to which the special tax treatment in the new section 72(n) applies may be illustrated by the following example: A, a sole proprietor, established a qualified pension trust to which he made annual contributions for 10 years of 10 percent of his self-employment earnings. A withdrew his entire interest in the trust during a taxable year for which, without regard to the distribution, he had a net operating loss and for which he is allowed under section 151 a deduction for one personal exemption. At the time of the withdrawal, A was 64 years old. The amount of the distribution that is includible in his gross income is \$25,600. For purposes of determining the tax attributable to the \$25,600, A's taxable income for the taxable year in which he received such amount is treated, under paragraph (3) of the new subsection (n), as being \$25,000 (\$25,600 minus \$600 (the deduction allowed for his personal exemp-

tion)). Thus, under paragraph (2) of the new subsection (n), the tax attributable to the $25,600 would be 5 times the increase in tax which would result if the taxable income of A for the taxable year he received such amount equaled $5,000 (20 percent of his taxable income determined under paragraph (3) of the new subsection (n)).

The application of the rules in paragraph (3) of the new subsection (n) in the case of a distribution to which section 72(m)(5) applies may be illustrated by the following example: Assume the same facts as in the example in the preceding paragraph except that A was 55 years old (and not disabled) at the time of the withdrawal. In addition, A had a net operating loss for the taxable year immediately preceding the taxable year in which he received the $25,600. The other 3 taxable years involved in the computations under section 72(m)(5)(B) were years of substantial income. For purposes of determining A's increase in tax attributable to the receipt of the $25,600 (before the application of the spreading provisions in section 72(m)(5)(B)), A's taxable income for the year he received the $25,600 is treated, under paragraph (3)(A) of the new subsection (n), as being $25,000 ($25,600 minus $600). For purposes of determining whether 110 percent of the aggregate increase in taxes which would have resulted if 20 percent of the amount of the withdrawal had been included in A's gross income for the year of receipt and for each of the 4 preceding taxable years is greater (and thus is the amount of his increase in tax attributable to the receipt of the $25,600), A's taxable income for the taxable year of receipt, and for the immediately preceding taxable year, is treated, under paragraph (3)(B) of the new subsection (n), as being $5,120 ($25,600 divided by 5).

Section 402(a)

Existing section 402(a)(2) provides that certain total distributions from qualified trusts are taxable at capital gains rates. Subsection (c) of section 4 of the bill amends section 402(a)(2) to provide that the capital gains treatment is not applicable to distributions paid to any distributee to the extent such distributions are attributable to contributions made by or for an individual while he was a self-employed individual. In other words, in the case of an individual who was covered under a qualified plan both while he was an employee within the meaning of common law and while he was a self-employed individual, the capital gains treatment could only apply to that part of a distribution that is attributable to contributions made on his behalf while he was an employee within the meaning of common law.

Section 403(a)

Existing section 403(a) provides the tax treatment for distributions under qualified nontrusteed annuity plans. Subsection (d)(1) of section 4 of the bill amends section 403(a)(2)(A)(i) to provide that a qualified annuity plan must meet the new qualification requirements included by this bill in section 401 (a) and (d).

Existing section 403(a)(2) provides capital gains treatment for certain total distributions under qualified annuity plans. Subsection (d)(2) of section 4 of the bill amends section 403(a)(2)(A) to provide that the capital gains treatment shall not apply to amounts paid to any payee to the extent such amounts are attributable to contributions made by or for an individual while he was a self-employed individual. This amendment applies similar treatment to distributions under

qualified annuity plans as the amendment made by subsection (c) of section 4 of the bill applies to distributions from qualified trusts.

Subsection (d)(3) of section 4 of the bill adds to section 403(a) a new paragraph (3) providing that, for purposes of section 403(a), the term "employee" includes a self-employed individual within the meaning of section 401(c)(2), and the employer of such individual is the person treated as his employer under section 401(c)(5). This amendment merely makes it clear that a self-employed individual can participate in a qualified annuity plan.

SECTION 5. PLANS FOR PURCHASE OF U.S. BONDS

Section 5 of the bill adds a new section 405 to the Internal Revenue Code of 1954 to provide for the establishment of qualified bond purchase plans.

Section 405(a)

Subsection (a) of the new section 405 provides that a plan of an employer for the purchase for and distribution to his employees or their beneficiaries of U.S. bonds described in section 405(b) shall constitute a qualified bond purchase plan if—

(1) the plan meets the requirements of section 401(a) (other than pars. (1), (2) and (12)) and, if applicable, the requirements of section 401(d) (other than pars. (1), (6)(B), and (8)); and

(2) contributions under the plan are used solely to purchase for employees or their beneficiaries the U.S. bonds described in section 405(b).

A qualified bond purchase plan can be established by an employer for his employees without the creation of a trust but, if such a plan is established, only the special bonds can be purchased under the plan. A qualified trusteed plan can also purchase the special bonds together with other assets but the plan must qualify under section 401 as a pension or profit-sharing plan.

In general, a qualified bond purchase plan must meet the same qualification requirements as a qualified annuity plan. However, section 401(d) (6)(B) and (8) is not applicable to a qualified bond purchase plan and, consequently, there is no limit on the amount of contributions in excess of those which are deductible that may be made under the plan.

Section 405(b)

Subsection (b)(1) of the new section 405 describes the special bond which can be purchased under a qualified bond purchase plan. Such paragraph provides that such a bond is a bond issued under the Second Liberty Bond Act, as amended, which by its terms, or by regulations prescribed by the Secretary of the Treasury under the Second Liberty Bond Act—

(A) provides for payment of interest or investment yield only upon redemption;

(B) may be purchased only in the name of an individual;

(C) ceases to bear interest, or provide investment yield, not later than 5 years after the death of the individual in whose name it is purchased;

(D) may be redeemed before the death of the individual in whose name it is purchased only if such individual—

(i) has attained the age of 59½ years, or

(ii) has become disabled (within the meaning of sec. 213(g)(3)); and

(E) is not transferable.

Subsection (b)(2) of the new section 405 provides that bonds purchased under a qualified bond purchase plan must be purchased in the name of the employee for whom it is purchased.

Section 405(c)

Subsection (c) of the new section 405 provides that contributions paid by an employer to or under a qualified bond purchase plan shall be deductible in an amount determined under section 404(a) in the same manner and to the same extent as if such contributions were made to a qualified trust described in section 401(a) which is exempt from tax under section 501(a). Thus, for contributions to a qualified bond purchase plan to be deductible under section 405(c), all of the requirements of section 404 must be met. For example, the contributions must meet the requirements of section 162 or 212, and must be made (or deemed to have been made under sec. 404(a)(6)) in a taxable year of an employer which ends with or within a year of the bond purchase plan for which it qualifies under section 405. If the amount of the contributions to the qualified bond purchase plan are determined by reference to the profits of the employer, as in the case of a qualified profit-sharing plan, the amount deductible with respect to such contributions is determined under section 404(a)(3), relating to qualified profit-sharing plans. Moreover, such a bond purchase plan shall be considered a profit-sharing plan for purposes of the provision in section 404(a)(3) relating to a situation when contributions are made to two or more profit-sharing trusts. In other cases, the amount deductible with respect to contributions to a qualified bond purchase plan will be determined under section 404(a)(1). If the qualified bond purchase plan covers owner-employees, the amount deductible with respect to contributions to the plan is subject to the further limitations of section 404(e) applicable to owner-employees. Similarly, in the case of a qualified bond purchase plan covering owner-employees, the special rules in section 404(a)(9) for computing the limitations with respect to deductions for contributions under the plan shall be applicable. Thus, the carryover provisions of section 404(a) are not applicable with respect to contributions made under a qualified bond purchase plan by or for owner-employees.

Section 405(d)

Subsection (d)(1) of the new section 405 provides that no amount is includible in the gross income of a distributee at the time a bond described in section 405(b) is distributed to him under a qualified bond purchase plan or from a qualified trust. Upon the redemption of such a bond, however, the proceeds are subject to taxation under chapter 1 of the Internal Revenue Code of 1954. In applying chapter 1, for purposes of determining the amount of tax due, the provisions of sections 72 and 1232 shall not be applied. In other words, the bonds described in section 405(b) received under a qualified bond purchase plan or from a qualified trust are not subject to tax until they are redeemed. In addition, upon redemption, no part of the proceeds will be taxable at capital gains rates under section 1232.

Subsection (d)(2) of the new section 405 provides rules for determining the basis of any bond received by a distributee under a qualified bond purchase plan. If the bond was purchased for an employee within the meaning of common law, the basis of such bond shall be an amount equal to the amount of the contributions made under the plan by the employee himself which were used to purchase the bond. If the bond was purchased for an employee at a time when he was a self-employed individual, the basis of such bond is an amount equal to the amount of the contributions used to purchase the bond which were made by or for such employee and which were not allowed as a deduction under section 405(c). Such subsection (d)(2) further provides that the basis of a bond described in section 405(b) which is received by a distributee from a qualified trust shall be determined under regulations prescribed by the Secretary or his delegate.

Section 405(e)

Subsection (e) of the new section 405 provides that the capital gains treatment of section 402(a)(2) shall not apply to any of the bonds described in section 405(b) and that, for purposes of applying section 402(a)(2) to amounts distributed by a qualified trust, any such bonds distributed to any distributee and any such bonds to the credit of any employee shall not be taken into account. In other words, for purposes of applying section 402(a)(2), a distribution under a qualified trust may be considered a total distribution of an employee's interest in such trust even though the trust retains bonds described in section 405(b). In the case of a distribution from a qualified trust which qualifies for the capital gains treatment of section 402(a)(2) and which includes both bonds of the type described in section 405(b) and other property, the capital gains treatment will be applicable to such other property. In no case, however, will the capital gains treatment be applicable to the proceeds received as a result of the redemption of any of the bonds described in section 405.

Section 405(f)

Subsection (f) of the new section 405 provides that, for purposes of section 405, the term "employee" includes an individual who is a self-employed individual within the meaning of section 401(c)(2), and the employer of such individual shall be the person treated as his employer under section 401(c)(5). Such subsection (f) has the effect of enabling the self-employed individual to participate in a qualified bond purchase plan to the same extent that he may participate in qualified pension, annuity, and profit-sharing plans.

Section 405(g)

Subsection (g) of the new section 405 provides that, at the time of the purchase of any of the bonds described in section 405, proof of such purchase shall be furnished in such form as will enable the purchaser, and the employee in whose name such bond is purchased, to comply with the provisions of section 405.

Section 405(h)

Subsection (h) of the new section 405 provides that the Secretary of the Treasury or his delegate shall prescribe such regulations as may be necessary to carry out the provisions of section 405.

SECTION 6. PROHIBITED TRANSACTIONS

Section 6 of the bill amends section 503 of the Internal Revenue Code of 1954 to provide a special definition of the term "prohibited transaction" in the case of certain qualified employees' trusts covering owner-employees. This special definition is only applicable when the owner-employees covered by the qualified employees' trust control the trade or business with respect to which the trust is established.

Section 6 of the bill adds to section 503 a new subsection (j) which provides that, in the case of a trust described in section 401(a) which is part of a plan covering owner-employees (as defined in sec. 401(c)(4)) who control the trade or business with respect to which the plan is established, the term "prohibited transaction" means, in addition to the transactions described in section 503(c), any transaction in which such trust, directly or indirectly—

(A) lends any part of the corpus or income of the trust to;

(B) pays any compensation for personal services rendered to the trust to;

(C) makes any part of its services available on a preferential basis to; or

(D) acquires for the trust any property from, or sells any property to;

any person described in section 503(c) or to any such owner-employee, a member of the family (as defined in sec. 267(c)(4)) of any such owner-employee, or a corporation controlled by such owner-employee through the ownership, directly or indirectly, of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of the corporation.

For purposes of determining whether owner-employees covered under a qualified employees' trust control the trade or business with respect to which such trust is established, the rules in section 401(d)(9)(B) are to be applied.

Paragraph (2) of the new subsection (j) provides that, for purposes of the new definition of "prohibited transaction" in paragraph (1), the following rules are to apply with respect to a loan made before the date of the enactment of the bill which would be a prohibited transaction if made in a taxable year beginning after December 31, 1961:

(A) if any part of the loan is repayable prior to December 31, 1964, the renewal of such part of the loan for a period not extending beyond December 31, 1964, on the same terms, shall not be considered a prohibited transaction.

(B) if the loan is repayable on demand, the continuation of the loan beyond December 31, 1964, shall be considered a prohibited transaction.

SECTION 7. OTHER SPECIAL RULES, TECHNICAL CHANGES, AND ADMINISTRATIVE PROVISIONS

Section 7 of the bill provides certain technical amendments and administrative provisions.

Section 7(a) of the bill amends section 37 of the Internal Revenue Code of 1954, relating to the retirement income credit, to make clear that any distribution to a self-employed individual under a qualified

pension, annuity, or profit-sharing plan, and any income derived by any person from the bonds described in section 405(b) received under a qualified bond purchase plan or from a qualified trust, may qualify as retirement income for purposes of such credit.

Section 7(b) of the bill amends section 62 of the Internal Revenue Code of 1954, relating to the definition of "adjusted gross income," to provide that, in computing adjusted gross income, there shall be allowed, in the case of a self-employed individual, the deductions allowed under sections 404 and 405 for contributions by or for such an individual to a qualified pension, annuity, profit-sharing, or bond-purchase plan.

Section 7(c) of the bill amends section 101(b) of the Internal Revenue Code of 1954, relating to employees' death benefits. Paragraph (1) of section 7(c) amends section 101(b) so that the rule applicable to distributions under a qualified annuity plan will only apply if the annuity plan meets the new qualification requirements of section 401 (a) and (d) applicable to annuity plans.

Paragraph (2) of section 7(c) amends section 101(b) by adding a new paragraph (3), which provides, in effect, that the death benefits exclusion provided by section 101(b) does not apply to amounts which are paid under a qualified pension, profit-sharing, or annuity plan, if such amounts are paid with respect to an individual who was a self-employed individual during any of the time he was covered by the plan.

Section 7(d) of the bill amends section 104(a) of the Internal Revenue Code of 1954, relating to compensation for injuries or sickness, to make clear that the exclusion of such section is not applicable to any benefits which are attributable to contributions to a qualified pension, annuity, or profit-sharing plan made by or for an individual while he was a self-employed individual, to the extent that such contributions were deductible under section 404.

Section 7(e) of the bill amends section 105 of the Internal Revenue Code of 1954, relating to amounts received under accident and health plans, by adding a new subsection (g) which provides that, for purposes of section 105, the term "employee" does not include an individual who is a self-employed individual within the meaning of section 401(c)(2). For example, if at the time an individual commences to receive benefits described in section 105 from a qualified pension plan, he is covered under such plan as a self-employed individual, such benefits do not qualify for the exclusion of section 105.

Section 7(f) of the bill amends section 172(d)(4) of the Internal Revenue Code of 1954, relating to net operating loss deductions, to make clear that any deduction under sections 404 or 405 attributable to contributions on behalf of a self-employed individual under a qualified employees' plan shall not be treated as attributable to the trade or business of such individual for purposes of section 172.

Section 7(g) of the bill makes conforming amendments to section 805 of the Internal Revenue Code of 1954, relating to pension plan reserves of life insurance companies.

Section 7(h) of the bill amends section 1361 of the Internal Revenue Code of 1954, relating to unincorporated business enterprises electing to be taxed as domestic corporations, to permit a partner or proprietor of such an unincorporated business to participate in a qualified pension, annuity, profit-sharing, or bond-purchase plan. However, for pur-

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poses of applying all the provisions relating to such qualified plans, such a partner or proprietor shall be considered a self-employed individual and will be considered an employee only to the extent he is so considered under section 401(c)(2).

Section 7(i) of the bill amends section 2039 of the Internal Revenue Code of 1954, relating to exemption from gross estate of annuities under certain trusts and plans. Paragraph (1) of section 7(i) amends section 2039(c)(2) to provide that the exclusion of the value of an annuity under a qualified annuity plan will be applicable only if the annuity plan meets the additional qualification requirements of section 401 (a) and (d). Paragraph (2) of section 7(i) amends section 2039(c) by adding at the end thereof a new sentence which provides that, for purposes of section 2039(c), contributions or payments on behalf of the decedent while he was a self-employed individual within the meaning of section 401(c)(2) made under a qualified pension, annuity, or profit-sharing plan shall be considered to be contributions or payments made by the decedent. Accordingly, the estate tax exclusion of section 2039(c) is not applicable to the portion of a decedent's interest in a qualified plan which is attributable to contributions made by or for an individual while he was a self-employed individual.

Section 7(j) of the bill amends section 2517 of the Internal Revenue Code of 1954, relating to exclusion from gift tax in case of certain annuities under qualified plans, in the same manner as section 7(i) of the bill amends the estate tax exclusion with respect to qualified plans.

Sections 7 (k) and (l) of the bill amend section 3306(b)(5) of the Internal Revenue Code of 1954 (relating to the Federal Unemployment Tax Act) and section 3401(a)(12) of such code (relating to the withholding of income tax). These amendments make conforming changes and exclude from the definition of "wages" under such sections any payment made to, or on behalf of, an employee or his beneficiary under or to a bond-purchase plan which, at the time of such payment, is a qualified bond-purchase plan described in section 405(a).

Section 7(m) of the bill amends the Internal Revenue Code of 1954 to add a new section 6047, giving the Secretary or his delegate authority to require the furnishing of additional information which is necessary to administer the new provisions in this bill. Section 7(m) of the bill also amends section 7207 of the 1954 code to provide penalties for willfully furnishing false or fraudulent information.

SECTION 8. EFFECTIVE DATE

Section 8 of the bill provides that the amendments made by this bill will be applicable to taxable years beginning after December 31, 1961.

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MINORITY VIEWS

H.R. 10 is concerned with the important subject of the establishment of tax-deferred retirement programs by the self-employed with respect to themselves and their employees. The purported purpose of the legislation is to establish a reasonable identity in the tax treatment of these individuals with respect to retirement plans as is accorded to corporate employees under present law.

The legislation makes a gesture toward tax equity in this area but unfortunately fails to achieve sufficient identity of treatment. Because the bill does not accomplish its intended purpose and because of the present fiscal posture of the Federal Government, the revenue loss from the enactment of the bill estimated by the Treasury Department at $358 million in the first full year of operation cannot be condoned at this time. The signatories to these views urge that the supporters of this legislation endeavor to have it taken into account in future Government budgeting so that its effect on fiscal balance need not be considered as a factor in evaluating the merits of the bill.

We recognize that an inequity does exist in present law in that certain of our citizens are allowed, and others are not, to participate in tax deferred pension plans. H.R. 10 would not equalize the tax treatment of our citizens in providing for retirement security but would instead result in the existence of different methods of tax treatment operating side by side, each applicable to a different group of taxpayers.

For example, these disparities would either be continued or created under this legislation: (1) Individuals working for self-employed employers not employing as many as four persons could continue to be discriminated against and precluded from participating in a retirement program; (2) contributions with respect to employees would be limited to earned income whereas contributions with respect to the self-employed would be on self-employment income, including both earnings and return on investment in the business; (3) lump-sum distributions in the case of the self-employed would be treated as ordinary income whereas such distributions to employees would be accorded capital gain treatment; (4) the vesting of an interest in a program would vary so that in the case of the self-employed and their employees (if four or more employees) a nonforfeitable right would attach immediately, but in the case of other types of beneficiaries such right may be forfeitable or nonforfeitable; and (5) various sets of limitations affecting coverage, contributions, and distributions would exist under the different statutory tests that would be applicable.

In seeking to ameliorate the present acknowledged discrimination in tax treatment with respect to retirement security, we must necessarily endeavor to achieve substantially similar treatment of all taxpayers. H.R. 10 would create more disparities than it would remove. In the area dealt with by this bill the details are important and we cannot responsibly limit our concern only to basic general principles.

It is entirely possible that precedents would be created under this legislation that could potentially unduly restrict programs to be established under the new authority or tend to impair existing programs. The fact that there is a problem to be solved in this area does not mean that we accept just any solution.

In the above enumeration of disparities reference was made in item (2) to the fact that contributions with respect to employees would be restricted to a percentage relation to earned salaries whereas in the case of the self-employed the restriction would apply to a percentage relation to self-employment income. It is significant to note that $100 million of the $358 million revenue loss is attributable to this more liberal definition of income for the self-employed.

The present version of H.R. 10 contains numerous and significant changes from the versions that have been previously considered by the House. Because this is a different bill, we are of the view that the committee did not give the careful consideration to the changes that they required.

For the above-stated reasons, we are constrained to oppose the enactment of H.R. 10 in its present form.

Noah M. Mason.
John W. Byrnes.
Thomas B. Curtis.
Bruce Alger.

[H.R. 10][1]

SELF-EMPLOYED INDIVIDUALS TAX RETIREMENT ACT OF 1961 [1962][2]

[Senate Report No. 992, Eighty-seventh Congress, First Session, Calendar No. 973]

[September 13, 1961]

Mr. Smathers, from the Committee on Finance, submitted the following report together with minority views to accompany H.R. 10.

The Committee on Finance, to whom was referred the bill (H.R. 10) to encourage the establishment of voluntary pension plans by self-employed individuals, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

I. Summary of Bill

Your committee's bill, which is in the form of a substitute for the House bill, is designed to encourage the establishment of voluntary retirement plans by self-employed persons by allowing self-employed individuals to be covered by qualified plans and by extending to them some of the favorable tax benefits present law now provides in the case of qualified retirement plans established by employers for their employees. To accomplish this purpose, self-employed persons are treated for retirement plan purposes as the employers of themselves. This was the fundamental concept of the House bill and it is retained in your committee's substitute. As employers, self-employed individuals are permitted, like other employers, to deduct contributions (within specified limits) made to pension or profit-sharing plans for the benefit of themselves and such other employees as may be covered under the plan. As employees, as with other employees, they are not taxed on such contributions made for their benefit, or the income thereon, until they receive the funds upon retirement or otherwise. Benefits for the self-employed individual may not, under either

[1] Public Law 87-792, page 89, this Bulletin.

[2] Enacted, October 10, 1962, as the "Self-Employed Individuals Tax Retirement Act of 1962."

the House bill or your committee's substitute, begin before age 59½ (except in case of early disability or death) nor later than age 70½. The retirement income credit will apply to retirement benefits distributed to self-employed individuals.

By treating self-employed individuals as employees under retirement plans there are brought into play (although with material modification) most of the statutory and administrative rules presently applicable to such plans. In addition, your committee's substitute also establishes additional rules to govern retirement plans which cover self-employed individuals.

Generally, a self-employed person who owns more than a 10-percent interest in his business (described as an owner-employee by the bill) is allowed under this bill to contribute each year to a retirement plan for himself up to 10 percent of his earned income for that year or $2,500, whichever is smaller. However, not all of the amount actually contributed for a self-employed person may be deducted for tax purposes. Rather, the first $1,000 so contributed and 50 percent of the contribution in excess of $1,000 may be deducted each year. This means that an owner-employee who makes the maximum annual contribution of $2,500 may deduct $1,750 of that amount. In order for an owner-employee to participate in a retirement plan under your committee's bill, it is necessary that he provide retirement benefits for his employees if he has any. The plan may not exclude any employee (other than part-time, seasonal and temporary employees) who has at least 3 years of service. Contributions for employees must meet the nondiscriminatory rules of existing law, and for this purpose a self-employed person is considered an employee. Thus, the plan ordinarily could not permit a greater proportion of covered earnings to be contributed for a self-employed person than for his employees. Another requirement of your committee's substitute is that contributions for employees must be nonforfeitable at the time they are made. These are tighter rules than under existing law, but your committee is convinced they are essential in order to prevent retirement plans of owner-employees from becoming purely income-averaging devices and to insure that contributions made for their employees do not inure to the benefit of owner-employees. Moreover, since a self-employed person would be treated as an employee under the bill, and would be covered by an employee's retirement plan, your committee believes it is fair that he be required also to cover all his employees under the same plan and to give them the same vested rights to contributions made for them as he in fact has with respect to amounts contributed on his behalf.

If the self-employed person is a partner who does not own more than a 10-percent interest in the business (and thus is not an owner-employee), the bill does not limit the amount which the partnership may contribute for him under a retirement plan, provided contributions or benefits for him are not discriminatory under the plan formula. Nonetheless, the amount of this contribution which he may deduct for tax purposes is limited by the same rule as applies to owner-employees. Under this rule the self-employed individual could deduct the full amount of the first $1,000 of his contribution plus 50 percent of the remainder. If the plan does not cover any owner-employee (in other words, if no partner owns more than a 10-percent interest in capital or profits) the new requirements of the bill with respect to coverage of

employees, and vesting, will not apply. However, in such a case the plan would have to meet the conditions of existing law as to coverage and nondiscrimination.

The retirement fund which this measure allows self-employed persons to establish may be lodged with a bank as trustee (or as custodian if contributions are invested in stock of an "open-end" regulated investment company or in policies issued by an insurance company); it may be invested in nontransferable annuities with an insurance company or in nontransferable face amount certificates; or it may be invested in a new series of U.S. Government bonds authorized for this purpose. These new bonds will be nontransferable, nonredeemable before age 59½ (except in case of disability or death) and issued only in the names of individuals. They are intended to provide a convenient and simple form of investment for retirement funds.

More than 7 million self-employed persons who pay income taxes would be permitted to establish retirement plans under this bill. Because self-employed persons generally have only a limited number of employees, their retirement plans will ordinarily be much smaller in scope than most of the corporate plans already in existence. Thus they would, if present law rules were not supplemented, offer somewhat greater opportunities for abuse than do corporate plans covering many employees. For this reason, tighter rules for retirement plans covering owner-employees are believed to be necessary. Several such rules were included in the House bill but they applied only where there were more than three employees. Your committee has accepted the suggestion of the Treasury Department that these rules be applied to all plans covering owner-employees. Thus, owner-employees are required to cover all of their employees who have more than 3 years of service if the owner-employee desires to participate in a retirement plan. Under existing law, some employees could be excluded under a nondiscriminatory classification and the plan could exclude all employees who had less than 5 years of service. Also, contributions made for employees of owner-employees must be nonforfeitable at the time they are made.

In addition, a new rule for coordinating retirement plans with social security is provided if an owner-employee is covered by the plan. Under this rule, the owner-employee will take into account only the employer portion of the social security tax. Under the more liberal provisions of existing law, the employer generally may take into account social security benefits not attributable to the employee portion of the social security tax.

The following chart compares the principal provisions of the House bill and of your committee's substitute.

SUMMARY COMPARISON OF PRINCIPAL PROVISIONS OF HOUSE BILL AND FINANCE COMMITTEE SUBSTITUTE

House bill	*Finance Committee substitute*
1. Basic concept	
Self-employed persons generally would be treated as employees for retirement plan purposes and are eligible for coverage in qualified plans. All separate businesses controlled by a self-employed person would be considered as one business for his retirement plan purposes.	Same as House bill.
2. Coverage for employees of self-employed individuals	
Self-employed persons establishing pension plans for themselves would be required to cover employees in the plan only if they have more than three employees. In this case all full-time employees, with more than 3 years of service would have to be covered under nondiscriminatory retirement plans set up under the rules of present law with certain modifications to cover self-employed individuals. Seasonal, part-time, and temporary employees could be excluded. Applicable only to more-than-10-percent owners.	Self-employed persons establishing retirement plans for themselves would be required to cover all full-time employees with more than 3 years of service. Seasonal, part-time, and temporary employees could be excluded. Applicable only to more-than-10-percent owners.
3. Base for deduction	
Self-employment earnings. This term means net earnings from trade or business of a self-employed person, including return on capital invested in the trade or business, as well as income for personal services.	Earned income. This term means professional fees and other compensation for personal services. Where both capital and personal services are material income-producing factors, the term means 30 percent of the income from the business or up to $2,500 whichever is greater.

4. *Amount deductible annually by self-employed individuals*

(*a*) Ten percent of self-employment earnings or $2,500, whichever is less, in the case of self-employed individuals with three or fewer employees. Applicable only to more-than-10-percent owners.	(*a*) A self-employed person who is a more-than-10-percent owner could contribute to a retirement plan 10 percent of his earned income or $2,500, whichever is the lesser. He could deduct the full amount contributed, up to $1,000 and 50 percent of the amount over $1,000 which may be contributed. Maximum deduction would be $1,750.
(*b*) An amount proportional to contributions made for employees, in the case of self-employed persons who have had more than three employees in any year. No maximum dollar limitation. Applicable only to more-than-10-percent owners.	(*b*) A self-employed person who does not own more than 10 percent of his business could contribute to a retirement plan any amount determined under a nondiscriminatory plan formula. He could deduct the full amount contributed up to $1,000 and 50 percent of the amount over $1,000. No maximum dollar limitation imposed.
(*c*) A self-employed person who does not own more than 10 percent of his business could contribute and deduct any amount determined under a nondiscriminatory plan formula.	

5. *Vesting*

(*a*) In plans covering self-employed persons with more than three employees, immediate vesting would be required. Applicable only to more-than-10-percent owners.	In plans covering self-employed persons immediate vesting would be required with respect to amounts contributed for employees. Applicable only to more-than-10-percent owners.
(*b*) In plans covering self-employed persons with three or fewer employees, no provision.	

House bill	*Finance Committee substitute*
6. Coordination with social security	
(*a*) Coordination would be permitted for plans covering self-employed persons with more than three employees if contributions for such self-employed persons do not exceed one-third of the total deductible contributions. Plan is given credit only for actual social security contributions made by the employer. Applicable only to more-than-10-percent owners. (*b*) In case of self-employed persons with three or fewer employees, no provision.	Coordination would be permitted for plans covering self-employed persons if contributions for self-employed persons do not exceed one-third of the total contributions. Plan is given credit only for actual social-security contributions made by the employer. Applicable only to more-than-10-percent owners.
7. No capital gains treatment	
Special averaging provided instead of capital gains treatment with respect to lump-sum distributions received by self-employed persons.	Same as House bill.
8. Estate and gift-tax exclusions	
Self-employed individuals not eligible for estate and gift-tax exclusions.	Same as House bill.
9. Limitation on time of payment of benefits	
Benefits could not be payable to more-than-10-percent owners before age 59½ (except in the case of permanent disability or death) but must begin before age 70½.	Same as House bill.
10. Face-amount certificates	
Investment in nontransferable face-amount certificates permitted.	Same as House bill.

11. Custodial account	
Custodial account in a bank is permitted in lieu of trust if investments are solely in regulated investment company stock.	Custodial account in a bank is permitted in lieu of trust if investments are solely in regulated investment company stock or life insurance policies. In this connection the committee included in the term "bank" various institutions regulated by State banking authorities.
12. Bond purchase plan	
Direct deductible investment in special issue of nontransferable retirement bonds would be permitted.	Same as House bill.
13. Attribution rules	
No provision.	Contains provision designed to prevent an individual from avoiding the special rules applying to owner-employees by fragmenting ownership interests among his spouse, descendants, and ancestors.
14. Effective date	
Taxable years beginning after December 31, 1961.	Same as House bill.

II. Reasons for the Bill

The primary reason for the House bill (as amended by your committee) is to give self-employed persons access to retirement plans on a reasonably similar basis to that accorded corporate stockholder employees. It thus tends to correct a discrimination in present law under which self-employed individuals—sole proprietors and partners—are prevented from participating in retirement plans established for the benefit of their employees although owner-managers of corporations may do so. Self-employed individuals have contended for many years they are treated unfairly under present law.

Several House-passed bills referred to your committee in prior Congresses would have allowed self-employed individuals to deduct amounts contributed by them toward the purchase of a "restricted retirement policy," or to a "restricted retirement trust," for their own benefit without requiring them to provide any retirement benefits for their employees. These measures did not treat self-employed persons as if they were employees, but were designed to equate, roughly, the tax benefits allowed qualified employee retirement plans under present law. In 1960, at the request of your committee, the Treasury Department submitted an approach to the retirement problem of self-employed persons which was different from earlier legislative proposals. In effect the approach submitted by the Treasury Department would have granted self-employed individuals tax treatment comparable to that received by employees now covered by qualified pension plans by permitting them to participate in pension plans in much the same manner as employees. This approach, however, not only would have imposed additional restrictions on the participation of self-employed persons in qualified pension plans but also would have imposed similar restrictions on the participation of corporate owner-managers in such plans. Neither the House bill nor your committee's substitute would restrict participation by owner-managers in retirement plans established by a corporation. With this exception, your committee's substitute substantially adopts the approach presented last year by the Treasury Department.

The bill allows contributions to retirement plans to be a deduction for income tax purposes at the time these contributions are made, but requires that retirement benefits when received be subject to taxation. Your committee's substitute, like the House bill, thus allows deferment of tax on certain forms of savings set aside for retirement, but limits the amount of these retirement savings of self-employed persons which are so treated. Since the self-employed person is viewed as both an employer and as an employee, this deferral is consistent with present law, under which employers are permitted to deduct contributions to qualified pension plans for their employees, while employees are not required to include in their incomes such contributions, or the income thereon, until they are received as benefits under the plan.

Your committee, like the Committee on Ways and Means of the House, is of the opinion that extending the coverage of individuals under voluntary retirement plans is in the public interest. The bill will make self-employment somewhat more attractive than at present compared to employment with a corporation, and will thus help to keep small business strong and independent professional practice

thriving. In many cases, self-employed individuals are prohibited by State law from operating their trade or business in the form of a corporation. Thus, in these cases, there is no possibility that a self-employed person could obtain the benefits of a retirement plan under existing law by forming a corporation to conduct his trade or business and becoming its employee. Although a number of States recently have enacted new legislation to eliminate some of the obstacles to professional corporations and associations, your committee believes it desirable to provide by Federal legislation that a self-employed individual may participate in employee retirement plans without becoming an artificial employee of his own corporation. Thus, professional individuals could continue to practice their profession in the traditional manner; that is, as self-employed individuals. Moreover, this legislation would ease the pressure on State legislatures to enact special professional corporation laws.

III. Present Law

Present law accords favorable tax treatment to pension and profit-sharing plans established for the exclusive benefit of employees or their beneficiaries. Employees covered under qualified plans are not taxed currently on contributions made on their behalf to these plans by their employers nor on the income from amounts so contributed. Instead, the employees generally include the benefits from such plans in taxable income only in the year they are received or made available.

The deferment of tax on retirement benefits until ultimate distribution applies whether or not the employee has vested (nonforfeitable) rights in the contributions made on his behalf. Typically, under corporate plans the employee does not have immediate vested rights to all such contributions, although plans vary considerably; they range from immediate vesting to vesting after attaining a certain number of years of service or attaining a specified age, or upon actual retirement.

The income of trusts established to administer qualified pension plans is exempt from income tax. Similarly, the Life Insurance Company Income Tax Act of 1959 granted exemption to income on insurance reserves established in connection with qualified pension plans. In addition, under present law, employers are permitted to take tax deductions (within specified limits) for their contributions to qualified plans. The law grants this favored tax treatment only to retirement plans which do not discriminate as to coverage, contributions, or benefits in favor of employees who are stockholders, officers, or supervisors, or employees who are highly compensated.

A qualified retirement plan cannot provide a higher rate of contribution or benefit for higher paid employees than for lower paid employees, or for shareholder employees than for those who are not shareholders. However, the dollar amount of benefits or contributions for the higher paid employees may be larger than for the lower paid employees, provided that such amounts constitute a uniform percentage of the compensation of participants.

Under appropriate circumstances, the private plan may be integrated with the social security system; if thus integrated, the proportion of social security benefits not attributable to the employee's own contributions is taken into consideration in determining whether the

contributions or benefits paid by the private plan meet the nondiscrimination test. Under the law and administrative rules the benefits of the higher paid employees, after being combined with a designated portion of social security benefits, must not be larger in relation to salary than the similarly combined benefits of lower paid employees.

Under existing law more than 66,000 corporate pension plans have been established. These plans cover more than 20 million employees and have, at the present time, somewhat more than $40 billion in assets. Corporations contribute more than $4 billion per year to qualified retirement plans.

IV. Revenue Effect

The revenue loss under your committee's bill is estimated to amount to $65 million for fiscal year 1962 and $180 million in a full year of operation. The estimated cost of H.R. 10 as passed by the House was $125 million for fiscal year 1962 and $325 million to $358 million in a full year of operation.

The lower cost of your committee's bill is due primarily to the following factors: (*a*) The basis for the retirement contribution deduction for the self-employed is earned income, while under the House bill the basis was net earnings from self-employment; (*b*) for those self-employed individuals electing coverage all full-time employees with more than 3 years of service would have to be covered, whereas under the House-passed bill only owner-employees with more than three employees were subject to this requirement; and (*c*) the amount of retirement contributions for self-employed which may be deducted is limited to 100 percent of the first $1,000 contributed and 50 percent of the remaining contribution permitted, and the maximum allowable deduction for owner-employees is $1,750; under the House bill self-employed persons with three or fewer employees were permitted to contribute, and deduct, up to 10 percent of self-employment earnings or $2,500, whichever was smaller, while for self-employed persons with more than three employees, there was no dollar limitation provided the ratio of contributions for the self-employed to their self-employment earnings did not exceed the ratio of contributions to wages for any of their employees.

V. Effective Date

Your committee's substitute, like the provisions of the House bill, are made applicable to taxable years beginning after December 31, 1961.

VI. General Explanation of Bill

A. SELF-EMPLOYED PERSONS AS OWNER-EMPLOYEES

The bill as reported by your committee provides a series of special requirements for qualification of retirement plans which cover self-employed individuals (sole proprietors and partners) having more than a 10-percent interest in the business with respect to which the plan is established. Under your committee's substitute, as under the House bill, such self-employed individuals are characterized as "owner-employees". In the case of a partnership where no partner owns more than 10 percent of the business, the self-employed indi-

viduals are also permitted to participate in pension plans, but because they are not owner-employees, plans covering them will, in general, be governed by the nondiscriminatory rules of present law, except where the bill imposes additional restrictions on self-employed individuals generally. In some situations, the bill imposes reactions upon all self-employed persons regardless of their percentage of ownership. (For example, limitation on the amount of contribution which may be deducted, denial of capital-gains treatment on lump-sum distribution, and the denial of the estate and gift tax exclusions.)

B. SELF-EMPLOYED RETIREMENT PLANS

Subject to limitations, your committee's bill would allow self-employed individuals (including partners) to be covered in qualified retirement plans. This would permit self-employed individuals to secure the benefits of current tax deductions, plus a tax-free buildup of pension fund investments, by establishing a plan which meets the requirements of the Internal Revenue Code. The bill treats plans covering self-employed persons under additional new rules established for that purpose.

Under your committee's bill, in the case of an owner-employee, the plan must provide retirement benefits for all employees (except part-time and seasonal employees) who have more than 3 years' service and contributions for such employees must be vested at the time they are made. Although the present law provides that some employees may be excluded from pension plan coverage on the basis of a "reasonable classification," and specifically provides that a plan may cover only salaried or clerical workers, your committee believes it desirable to require an owner-employee to cover all of his employees except seasonal, temporary, and part-time workers, and full-time employees who have less than 3 years of service. With these exceptions employees must be covered whether they are salaried employees or wage earners, and whether or not they work in different departments or enterprises. Under present law, retirement plans can exclude employees with up to 5 years of service, and contributions for employees are not required to be vested. If there are no employees, a self-employed individual would be permitted to establish a retirement plan for himself.

Your committee understands that some self-employed individuals have established pension plans for their employees under existing law (although they, themselves, cannot participate under them). The self-employed individuals would become "employees" upon enactment of this bill, and in most cases they would be "owner-employees". In the absence of specific provision for these cases, plans covering owner-employees would be required to meet all the tests of this bill or lose tax-favored status. These plans were created with no thought of coverage of their self-employed creators and it may be that for reasons of their own, the self-employed owners would not desire to be covered by their plans. In such cases, it would be unjust to impose the restrictions of this bill upon these plans. Thus, your committee has provided that owner-employees must "consent" to be covered by their plans before the special rules of this bill will apply.

C. EARNED INCOME

The measuring rod for deductible contributions for self-employed persons under your committee's bill is "earned income". This means that contributions by or for a proprietor or partner may be made under a qualified retirement plan only if he performs personal services. Since the objective of such a plan is to provide retirement benefits based on personal services, inactive owners who derive their income entirely from investments would not be allowed to participate. This concept of earned income is designed to place proprietors and partners on the same basis as corporate shareholders who can participate in a qualified retirement plan under present law only if they are employees of the corporation. Contributions to a retirement plan for self-employed individuals who are engaged in activities involving significant capital investment are based only on that part of the business income which is attributable to personal services. Thus, under the bill, "earned income" is defined generally as income from self-employment, but where such income is derived from a trade or business in which both capital and personal services are material income-producing factors, the term means not more than 30 percent of the net profits from the trade or business or $2,500, whichever is the greater, except that where net profits of a proprietor or partner from his trade or business are $2,500 or less, the entire amount of such profits is deemed to be earned income.

Under this concept of "earned income" the entire amount received by a self-employed individual as professional fees or commissions will be treated as earned income if the taxpayer is engaged in the practice of a profession, such as medicine or law, even though he employs assistants to perform part or all of the services, provided the patients or clients are those of the taxpayer and look to him as the person responsible for the services rendered. Your committee's bill permits doctors and ministers as well as certain people who perform services for compensation in their own homes and commissioned salesmen (other than full-time life insurance salesmen who are treated under present law as employees for pension purposes) to participate even though they do not have self-employment income within the meaning of the Internal Revenue Code.

The following illustrations indicate the determination of earned income in various situations:

1. A doctor has net profit of $40,000 from professional services. His patients look to him as the person responsible for the services rendered. The full amount of this net profit constitutes earned income.

2. A self-employed grocer has net profit of $40,000 from his wholly owned retail grocery business. Both capital and personal services are material income-producing factors. His earned income is $12,000 (30 percent of $40,000).

3. A gasoline service station operator has net profit from his wholly owned unincorporated service station of $2,400. Both capital and personal services are material income-producing factors. Under the bill, the entire amount of such net profit is deemed to be earned income since it does not exceed $2,500.

4. A contracting partnership composed of three partners who share equally in its profits has partnership net profit of $22,500. Both

capital and personal services are material income-producing factors. Of the $7,500 attributable to each partner, $2,500 constitutes earned income (30 percent of $7,500, or $2,500 whichever is greater, where each partner's share of net profits exceeds $2,500).

5. A and B are partners in a stock brokerage firm. A supplies all necessary capital but performs no personal services. B has no capital interest, but performs all personal services required by the firm. They share profits equally. Both capital and personal services are material income-producing factors. The firm has net profit from brokerage commissions of $50,000 and total net profit from all sources of $70,000.

A has no earned income from the partnership since he performed no personal services.

B has earned income of $10,500 (30 percent of $35,000).

D. LIMITATIONS ON CONTRIBUTIONS AND DEDUCTIONS FOR SELF-EMPLOYED

The bill restricts the amount of deductible contributions which may be made by or for a self-employed individual covered by a plan.

Owner-employee.—If the owner-employee has employees, in order for him to make any contribution for his own retirement needs he must provide nonforfeitable retirement plan coverage for all his employees who have more than 3 years' service. Having established a qualified plan for himself and his employees, an owner-employee under the bill is permitted to contribute for himself up to 10 percent of his earned income or $2,500, whichever is the lesser, provided that contributions for himself are not discriminatory as compared to contributions for his employees under the plan formula. However, under your committee's bill he is not permitted to deduct the full amount allowed to be contributed. Rather, the deductible portion is subject to additional limitations. These limitations provide that amounts actually contributed, up to $1,000, may be deducted in full, but that only 50 percent of allowable contributions in excess of $1,000 which are made may be deducted. Thus, in the case of an owner-employee who makes the maximum allowable contribution of $2,500 the deductible amount is limited to $1,750 (100 percent of $1,000 plus 50 percent of $1,500, or $750).

The following examples illustrate the application of these limitations in the case of an owner-employee:

Example 1: A commission salesman has earned income of $23,000. He has no employees. Under the bill he establishes a qualified retirement plan under which he will be the only beneficiary. The plan calls for contributions of 10 percent of earned income. The salesman contributes to the plan $2,300 (10 percent of $23,000). Of this amount he may deduct $1,650 (100 percent of the first $1,000 contributed plus 50 percent of the remaining $1,300 contributed, or $650).

Example 2: A real estate broker with four full-time employees has earned income of $30,000 from commission selling. He anticipates that it will continue at or above that level. All employees have more than 3 years' service. Two of the employees earn $4,000 each, the other two earn $10,000 each. He establishes a qualified retirement plan which calls for nonforfeitable contributions for each employee who has more than 3 years' service of 10 percent of his earnings and

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for contributions for owner-employees of 10 percent of earned income. Thus, for his employees, the owner-employee would contribute, and deduct, \$2,800 (10 percent of \$28,000). And, for himself, he would contribute \$2,500 (the lesser of \$2,500 or 10 percent of \$30,000). Of this amount, he would deduct \$1,750 (100 percent of the first \$1,000 contributed and 50 percent of the remaining \$1,500 which he is permitted to contribute).

If, under the circumstances described above, the real estate broker had established a plan calling for that contribution percentage which, when applied to his earned income would ordinarily produce the maximum contribution for himself at the lowest cost, the plan would call for nonforfeitable contributions for himself and for each employee of 8⅓ percent of earnings. Thus, for his employees, the owner-employee would contribute, and deduct, \$2,333 (8⅓ percent of \$28,000). And, for himself, he would contribute \$2,500 (the lesser of \$2,500 or 8⅓ percent of \$30,000) and deduct \$1,750 (100 percent of the first \$1,000 contributed and 50 percent of the remaining \$1,500 which he contributed).

Self-employed individuals who are not owner-employees.—Self-employed individuals who do not own more than a 10-percent partnership interest in their trade or business are limited as to the amount of contributions they may make (through the partnership) to a qualified retirement plan only by the requirement that contributions must not be discriminatory under the plan formula. Thus if such a self-employed individual has sufficient earned income in a taxable year to permit a contribution in excess of \$2,500, it may be made. However, your committee's bill imposes the same limitations as to deductibility of such contributions as those applied to contributions made by owner-employees; that is, the first \$1,000 of actual contributions may be deducted in full but only 50 percent of contributions in excess of \$1,000 may be deducted.

The following examples illustrate the application of these limitations in the case of a self-employed person other than an owner-employee:

(1) A owns a 10-percent interest in a partnership in which only personal services are a material income-producing factor. He derives earned income of \$30,000 a year from the partnership. The partnership has established a qualified retirement plan which calls for nonforfeitable contributions for employees of 10 percent of their salary and contributions for owner-employees and other self-employed individuals of 10 percent of their earned income. The partnership contributes for A \$3,000 under the plan (10 percent of \$30,000). A deducts \$2,000 (100 percent of the first \$1,000 actually contributed plus 50 percent of the remaining \$2,000).

(2) B owns a 10-percent interest in a partnership in which both capital and personal services are material income-producing factors. His income from the partnership amounts to \$30,000. His earned income is \$9,000 (30 percent of \$30,000). The partnership establishes a qualified retirement plan which calls for nonforfeitable contributions for employees of 10 percent of their salary and contributions for owner-employees and other self-employed individuals of 10 percent of their earned income. The partnership contributes for B \$900 under the retirement plan (10 percent of \$9,000) and B deducts the entire amount.

E. VESTED BENEFITS

The bill, as approved by your committee, adds new requirements to the statute relating to vesting of benefits or contributions made for employees.

In the case of owner-employees with employees, contributions for employees with more than 3 years' service must be nonforfeitable at the time they are made under a plan. This requirement is made a condition governing the qualification of a plan covering such owner-employees, and unless a provision for vesting is included in the terms of the plan a contribution for owner-employees would not be allowable nor would it be deductible. Your committee believes that because an owner-employee always has a vested right to contributions he makes to a retirement plan for his own benefit, it is only fair and equitable that he provide similar vested rights for his employees.

Your committee has provided a single, conditional exception to these vesting rules in the case of retirement plans covering owner-employees. This exception provides that the vesting requirement will not apply if the result upon termination of the plan is to provide discriminatory benefits for certain highly paid employees or owner-employees. This is an exceptional situation and your committee believes it would be appropriate to provide this special exception in order to prevent abuses.

If a plan does not cover any owner-employee, the special requirement as to vesting will not apply. In such a case where a partnership is composed of partners, none of whom owns more than a 10-percent interest, the rules of present law would apply and the plan could provide for complete vesting, partial vesting or no vesting until retirement.

F. INTEGRATION WITH SOCIAL SECURITY

Under your committee's bill, as under the House bill, retirement plans covering owner-employees may be integrated, or coordinated with social security under special rules provided by the bill. Under such integration, or coordination, the overall cost of a retirement plan might be materially reduced. Under present law as applied to qualified pension plans integration is permitted under rules which assume that the employer has paid for that portion of the social security benefit for which the employee himself has not paid.

Under this bill, if an owner-employee with employees establishes a retirement plan which meets the prescribed requirements and if allowable contributions (upon which the deduction is based) for owner-employees are not more than one-third of the total allowable contributions made under the plan, owner-employees, if they take into account the self-employment tax paid on their own behalf (or which would be paid except for the fact that such owner-employee is not covered by social security), may also take into account the employer portion of the FICA tax paid on behalf of covered employees. The method of coordinating such a pension plan and social security payments under your committee's bill is different from the method permitted by Treasury rulings under the provisions of present law. Under this bill the owner-employee may take into account only the amount of social security taxes actually paid by him for his employees

whereas the rules under present law, in effect, permit the employer to take into account social security benefits not attributable to employee taxes. The following example illustrates the application of this rule.

A and B, equal partners in a contracting business in which capital is a material income-producing factor, have five employees, each of whom has more than 3 years' service. A retirement plan is established under which employees with more than 3 years' service will be given immediate nonforfeitable rights to contributions made on their behalf. The plan calls for contributions of 10 percent of gross wages for covered employees, and of 10 percent of earned income for owner-employees, with provision for coordinating the plan with social security. Wages of employees and net profits of the partners appear in the following schedule, along with other pertinent information.

	Net profits or wages		Contribution		
	Per person	Total	10 percent of wages of employees and 10 percent of earned income of owner-employees	Credited self-employment tax and FICA tax paid by employer [1]	Net contribution under integrated plan
2 partners	[2] $25,000	[2] $50,000	$1,500	$451.20	$1,048.80
3 employees	6,000	18,000	1,800	450.00	1,350.00
1 employee	6,800	6,800	680	150.00	530.00
1 employee	3,170	3,170	317	99.06	217.94
Total, partners		[2] 50,000	1,500	451.20	1,048.80
Total, employees		27,970	2,797	699.06	2,097.94
Total, partners and employees		77,970	4,297	1,150.26	3,146.74

[1] Self-employment tax, 4.7 percent of employer's self-employment earnings up to $4,800; FICA tax, 3⅛ percent of employee earnings up to $4,800.
[2] Earned income would be 30 percent of this amount.

Thus, since contributions for owner-employees after coordination with social security ($1,048.80) do not exceed one-third of net contributions under the plan ($3,146.74), social security and self-employment taxes may be taken into account. After coordination, $3,146.74 must be contributed under the plan, of which $1,048.80 is attributable to owner-employees and $2,097.94 is attributable to employees as shown in the schedule.

The coordination rule is further illustrated in the following table for several levels of partnership earnings (net profits). The table shows in column (6) the level of employee payroll at and above which a partnership with the earnings set forth in column (1) would be permitted to coordinate its retirement plan contributions with its social security contributions, assuming 80 percent of the total payroll is subject to social security taxes.

Level of employee payroll at and above which social security coordination would be permitted in 1962 for selected levels of partnership earnings under Senate Finance Committee substitute for H.R. 10

Derivation of contribution for owner-employees					Derivation of contribution for employees,				Total contribution	
Partnership earnings [1]	Partnership carned income [2]	10 percent of partnership earned income [3]	Self-employment tax [4]	Net contribution under integrated plan	Total employee payroll	10 percent of employee payroll	FICA tax on employee payroll [5]	Net contribution under integrated plan	Total net contribution	Total deductible contribution
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
$5,000	$5,000	$500	$235.00	$265.00	$7,066.67	$706.67	$176.67	$530.00	$795.00	$795.00
10,000	5,000	500	451.20	48.80	1,301.33	130.13	32.53	97.60	146.40	146.40
15,000	5,000	500	451.20	48.80	1,301.33	130.13	32.53	97.60	146.40	146.40
20,000	6,000	600	451.20	148.80	3,968.00	396.80	99.20	297.60	446.40	446.40
25,000	7,500	750	451.20	298.80	7,968.00	796.80	199.20	597.60	896.40	896.40
50,000	15,000	1,500	451.20	1,048.80	27,968.00	2,796.80	699.20	2,097.60	3,146.40	3,146.40
66,667	20,000	2,000	451.20	1,548.80	41,301.33	4,130.13	1,032.53	3,097.60	4,646.40	4,646.40
100,000	30,000	3,000	451.20	2,548.80	67,968.00	6,796.80	1,699.20	5,097.60	7,646.40	[6] 7,372.00
150,000	45,000	4,500	451.20	4,048.80	107,968.00	10,796.80	2,699.20	8,097.60	12,146.40	[6] 11,122.00
166,667	50,000	5,000	451.20	4,548.80	121,301.33	12,130.13	3,032.53	9,097.60	13,646.40	[6] 12,372.00
[7] 200,000	60,000	5,000	451.20	4,548.80	121,301.33	12,130.13	3,032.53	9,097.60	13,646.40	[6] 12,372.00
[7] 333,333	100,000	5,000	451.20	4,548.80	121,301.33	12,130.13	3,032.53	9,097.60	13,646.40	[6] 12,372.00

[1] Assumes 2 partners sharing equally in the earnings.

[2] Actual earnings of owner-employees with actual earnings up to $2,500; $2,500 for owner-employees with actual earnings between $2,500 and $8,333; 30 percent of actual earnings for owner-employees with actual earnings of $8,333 and over.

[3] With contribution ceiling of $2,500 per owner-employee; it is assumed that capital is a material income-producing factor.

[4] 4.7 percent of each partner's self-employment income up to $4,800.

[5] 3⅛ percent of FICA taxable payroll; FICA taxable payroll assumed to be 80 percent of total employee payroll.

[6] Figure in previous column less ½ of the net contribution for each owner-employee which falls between $1,000 and $2,500.

[7] Although the data in this line were developed on the basis of a contribution percentage of 10 percent with a $2,500 ceiling, the possibility should be noted that the owner-employees, when the earned income ascribed to each exceeds $25,000, might establish a plan calling for a lower contribution percentage designed to produce precisely the maximum contribution permissible on their behalf—8⅓ percent for an earned income of $30,000 each and 5 percent for an earned income of $50,000 each. If these latter percentages had been used, the payroll levels, which equate the net contribution on behalf of the owner-employees with twice that on behalf of the employees, would be $155,959 and $363,904, respectively.

G. METHODS OF FUNDING

Trusteed plans and employee annuity plans.—As with qualified plans under present law, qualified retirement plans covering self-employed individuals or self-employed individuals and their employees may be funded either through contributions to a trust or by purchase of annuity contracts (including variable annuity contracts) directly from an insurance company. Self-employed individuals establishing such plans for themselves, or for themselves and their employees, could, if they chose to do so, use associations to pool their separate funds for investment purposes.

Custodial accounts.—In addition, your committee's bill permits the use of a custodial account, in lieu of a trust, if its investments are made solely in stock of a regulated investment company which issues only redeemable stock, or solely in life, endowment, or annuity contracts issued by an insurance company. Although a custodial account may be utilized by a retirement plan, whether or not it includes an owner-employee, it will be particularly beneficial to small owner-employee-type plans because of its lesser costs. Such lesser costs result from the fact that the bank would not be required to assume the duties and responsibilities of a trustee, but would serve only as a mere custodian of amounts contributed under retirement plans or of the policies deposited with it.

Face amount certificates.—Your committee has also made it plain that retirement funds may be invested directly in nontransferable face-amount certificates, which would be treated for retirement plan purposes as annuities. Such certificates may presently be purchased by a trusteed plan under existing law, but not under nontrusteed annuity plans. Your committee's bill makes it clear that such certificates may in the future be purchased in the same manner as annuities. In this respect your committee's bill includes a requirement that annuity contracts purchased by a qualified retirement plan generally must be nontransferable. This requirement applies to all pension plans whether or not an owner-employee is covered.

Bond purchase plan.—A completely new form of retirement plan involving direct investment in a new series of Government bonds is authorized by your committee's bill. The principal features of the bond purchase plan are explained in section J below.

H. CONTRIBUTORY PLANS

Under the bill, retirement plans permitting or requiring additional contributions by employees, as well as those to which the employer alone makes contributions, may be established by an owner-employee with employees. If employees who are not owner-employees are permitted to make nondeductible contributions to the plan, such an owner-employee also may make nondeductible contributions on his own behalf up to 10 percent of his earned income or $2,500, whichever is the lesser; however, the rate of such contributions must not exceed the rate permitted for employees. In no event may such contributions by an owner-employee exceed $2,500. Such contributions will not be deductible either by employees or by owner-employees, but must be made out of income that has already been taxed. The making of such nondeductible contributions is beneficial, however, because

the income earned thereon will not be taxed until it is received from the fund, upon retirement or otherwise. While a similar tax-free buildup can be obtained by anyone purchasing a private life insurance, endowment or annuity contract, it is likely that the return under a qualified retirement plan would be somewhat greater or premiums somewhat lower because of the special deduction allowed life insurance companies with respect to their qualified pension plan reserves which may be passed on to policyholders.

The committee bill permits voluntary nondeductible contributions to be made by owner-employees at the same rate as by employees. Owner-employees who have no employees may not establish contributory retirement plans. Thus, if an owner-employee establishes a qualified retirement plan which calls for nonforfeitable contributions of 10 percent of salary of employees and 10 percent of earned income in the case of owner-employees and other self-employed individuals and if the plan permits voluntary contributions of 10 percent of salary to be made by employees, owner-employees and other self-employed individuals would be permitted to contribute on a voluntary basis 10 percent of their earned income up to a maximum of $2,500. If, in this case for example, the owner-employee has earned an income of $25,000 or more, he would deposit $2,500 as the maximum allowable "employer's" contribution and would be permitted to deposit an additional $2,500 as a voluntary nondeductible "employee's" contribution. Of course, as previously explained, only $1,750 of the allowable "employer's" contribution of $2,500 would be deductible.

I. PROFIT-SHARING PLANS

Your committee's bill does not limit participation of self-employed individuals to fixed-percentage contribution pension plans. Rather, it also permits them to participate in profit-sharing plans paying retirement benefits, under which contributions may be made in profitable years, but there would be no obligation to make contributions in years of little or no profit. To avoid the abuse of making larger or smaller contributions in years when surtax rates are lower or higher, the bill requires a definite formula for determining the amount of contributions to be made on behalf of employees who are not owner-employees. Because of the special limitations on allowable and deductible contributions which may be made by owner-employees covered under a profit-sharing plan, a definite formula would not be appropriate with respect to them. Consequently, in order for an owner-employee to participate in such a plan, it must provide a definite formula only for contributions for employees.

J. BOND PURCHASE PLANS

As an alternative form of investment which will be of particular interest to small businesses comtemplating pension plans, direct investment in U.S. Government securities of a new series is authorized both by the House bill and your committee's substitute. These new bonds, which must be issued in the names of the individual employees (including owner-employees) on whose behalf they are purchased (and thus will be nonforfeitable), will be nontransferable and may not be cashed until the individual in whose name the bonds

are issued has attained age 59½ (insurance age 60) or has become disabled or deceased. In order to prevent these bonds from being used for purposes other than retirement, the bill provides that interest on them must stop within 5 years after the death of the bond owner. This period corresponds generally to other provisions of the bill requiring disposition of a deceased owner-employee's interest in a retirement plan within a specified period of time after his death. The purpose of direct bond purchases under a qualified retirement plan is to avoid the expense of establishing a trust to administer the retirement fund assets. The new series of Government securities may also be purchased by the trustee of an existing pension plan if it is desired to make that form of investment.

Where a pension plan has invested in these retirement bonds, the bill provides that no income will be realized by the employee at the time the bonds are distributed to him; rather, the principal and interest on the bonds will be included in the employee's income at the time they are redeemed. Although these new bonds may be purchased by anyone, their cost will be deductible for income tax purposes only if they are purchased under a qualified bond purchase plan or by a qualified retirement plan. The amount deductible is to be determined in the same manner as if the cost of the bond were a contribution to a qualified retirement trust, except that the special rules relating to excess contributions in the case of owner-employee type plans do not apply. Those rules are considered inappropriate to qualified bond purchase plans not only because the special bonds might be purchased by anyone (and not solely for retirement purposes) but also because the denominations in which the bonds might be issued will not necessarily correspond to the amount which might be contributed and deducted by an owner-employee. Under the bond purchase plan as passed by the House and approved by your committee, income realized on the redemption of the special bonds (principal and interest where the cost of the bond was deducted, interest only in other cases) will always be taxed at ordinary rates. Moreover, there would be no capital gains treatment on a lump-sum distribution of these special bonds to an individual covered by a qualified pension trust. By making the earliest redemption date for these bonds age 59½, except in the case of death or disability, these bonds will generally be unattractive to ordinary investors because they may hesitate to freeze their capital for long periods of time.

K. EXCESS CONTRIBUTIONS

The bill as reported by your committee provides certain penalties where excess contributions are made under a pension plan on behalf of an owner-employee. Generally, under the bill, an excess contribution is an amount greater than the total of (1) allowable contributions, upon which the deductible amount is based, and (2) permitted voluntary contributions which in no case are deductible. The bill requires that any such excess contributions must be returned to the owner-employee on whose behalf it was made, together with income earned on the excess contribution. The income so returned will be taxable to the self-employed person for whom the contribution was made. If an excess contribution is not repaid within 6 months after notification has been received that the contribution was excessive, the plan

is temporarily disqualified (until the excess is returned) with regard to the person on whose behalf the excess contribution was made and he is taxed on the annual income earned by the entire fund in the plan which is attributable to his interest. Where an excess contribution is willfully made, however, the entire interest of the individual on whose behalf it was made in all plans in which he participated as an owner-employee (including the corpus allocated to his account) is required to be distributed to him, and he is further disqualified from participating in any pension plans as an owner-employee for a 5-year period. Furthermore, no opportunity is given to repay a willful excess contribution and escape the consequences.

Your committee has added an exception to the foregoing rules under which an owner-employee (but not a self-employed individual who is not an owner-employee) would be permitted to purchase annuity or life insurance or endowment policies on his life from an insurance company at level premiums without fear of making an excess contribution. Under this exception, an owner-employee would be permitted to contribute each year toward the purchase price of his policy up to an amount equal to the amount he would have been allowed to contribute on the basis of his average earned income for 3 years preceding issuance of the last such policy under the plan. Thus, for example, if an owner-employee who has earned income of $10,000 per year for a 3-year period contracts for a life insurance policy on his own life, and the annual premium thereon is $1,000, he may continue to contribute the amount of the premium annually even though his earned income falls below $10,000. Moreover, under this amendment if his earned income subsequently were to increase to an average of $15,000 per year for a 3-year period he could purchase additional policies calling for annual premiums of $500. Thereafter, he could continue to pay the premium of $1,500 per year despite a future drop in his earned income. However, amounts contributed under this exception will be deductible only to the extent that they are related to earned income for the taxable year. Thus, for example, while an individual under this rule may be permitted to purchase an annuity contract for a level premium of $1,000 a year, none of that purchase price would be deductible if the self-employed individual actually had no earned income for the taxable year. As previously explained, amounts contributed under a qualified bond purchase plan are not subject to the excess contribution rules. For reasons similar to those there stated, your committee is of the opinion that exception from the excess contributions rules in the case of life insurance, endowment or annuity contracts issued on the life of an owner-employee also is desirable. Moreover, this exception is limited so that under no circumstances could the owner-employee obtain under one or more retirement plans level-premium policies requiring annual payments of more than $2,500. If he does so, he forfeits the benefits of this exception and the entire amount of the premiums (not merely the amount in excess of $2,500), would be subject to the excess contribution rules.

L. PAYMENT OF BENEFITS TO OWNER-EMPLOYEES

Your committee's bill, like the House bill, requires that retirement plans established by owner-employees for their own benefit, or for

the benefit of themselves and their employees, may not begin paying retirement benefits to owner-employees before they reach age 59½ (insurance age 60) except in the event of death or disability. Under your committee's bill an individual is considered disabled if he is unable to engage in any substantial gainful activity because of a medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. Distribution of retirement benefits, however, must begin not later than 70½ (insurance age 70) in the case of owner-employees, and not later than age 70½ or the year in which he retires in the case of employees and self-employed individuals other then owner-employees. If an owner-employee dies, his remaining interest in the retirement plan must be (1) distributed to beneficiaries within 5 years from the date of his death or, if later, the death of his spouse, (2) used within 5 years to purchase an immediate annuity which will be payable over the beneficiary's life or over a period no longer than the beneficiary's life expectancy or (3) paid out under a plan of distribution already commenced, over a period no longer than the life expectancy of the employee or the joint life expectancy of the employee and his spouse.

If the distribution is made under alternative (1), above, and is completed within 1 taxable year of the beneficiary, the distribution would be treated under the special rules of the bill relating to lump-sum distributions and the special 5-year-averaging devise would apply. (See subdivision Q.) On the other hand, if the distribution is made as permitted by alternative (2), above, there would be no tax due upon distribution to the beneficiary of the annuity contract, but he would be taxable at ordinary income tax rates on amounts received by him under the annuity contract. Distributions under alternative (3), above, would be taxable at the time payments are received by the beneficiary under the annuity contract.

Your committee added the third alternative in order to eliminate the needless cancellation of one annuity contract and the issuance of another one which would pay out over the same period as the original.

M. PREMATURE DISTRIBUTIONS

A tax penalty is imposed by the House bill, and by your committee's substitute, in cases where a premature distribution of all or part of the retirement fund is made before the owner-employee reaches age 59½ or becomes disabled. Under both bills, in these cases, if the premature distribution amounts to $2,500 or more, the tax imposed would not be less than 110 percent of the increase in tax that would have resulted if the income had been received ratably over the 5 years ending with the year of distribution. If the premature distribution amounts to less than $2,500, the tax due would be 110 percent of the increase in tax resulting from inclusion of the entire amount of the premature distribution in gross income for the current year. In either event, the taxable income for the year in which the distribution occurs is treated as being not less than the excess of the amount of the distribution includible in gross income over the deductions allowable for personal exemptions. Any resulting increase in tax can be reduced only by the credit for withheld taxes. As a further penalty in case of a premature distribution, the owner-employee is disqualified from

participating in a retirement plan on his own behalf for 5 years following the year in which the distribution is made. These penalties are imposed in order to prevent retirement plans from, in effect, becoming income-averaging plans under which deductible contributions would be made to the plan in high-income, high-tax years and the assets would be drawn down in low-income or loss years when little or no tax would be due. It is the purpose of this bill to provide means for financing retirement; these penalties are designed to insure that retirement plans will not be used for other purposes.

N. TWO OR MORE BUSINESSES

An owner-employee (or a group of two or more owner-employees) who controls more than one business would be required under the bill to group together all controlled business activities, and coalesce them, for the purpose of determining whether all employees of the owner-employee are covered by a retirement plan, and also for the purpose of insuring that the limitations on contributions are not exceeded. Under this requirement, an owner-employee could not make contributions under two or more retirement plans, which, when totaled together, would exceed $2,500, nor could he deduct more than $1,750 in any taxable year. Thus, an owner-employee may not exceed the limitations on deductible contributions by splitting his activities among two or more businesses and establishing retirement plans in each, nor could he divide his businesses and set up a retirement plan in one business in which, for example, he is the only employee

The bill also provides that an individual who is an owner-employee in a business (whether or not he controls the business) and is also an owner-employee of another business which he controls may not be covered under the plan of the first business unless he has established a plan for the employees of the business which he controls. The plan for the business which he controls must provide contributions and benefits for employees which are at least as favorable as the contributions and benefits provided for owner-employees under the plan of the first business.

O. CONSTRUCTIVE OWNERSHIP

Your committee's bill includes rules (not included in the House bill) which attribute to a self-employed individual ownership interests in a trade or business which are held by his spouse or minor children. The bill also provides that an individual who owns any interest in a business or is an employee of the business is to be attributed with ownership interests in the business which are owned by his ancestors or lineal descendants. This will insure that no individual will be able to avoid the special requirements of the bill by arguing that he is not an "owner-employee," but merely an employee of a business owned by these close relatives. For example, although other provisions of law permit formation of valid family partnerships, by donation of ownership interests under which income will be taxed to the various family partners rather than to the donor of the ownership interests, your committee believes that for retirement plan purposes, such a donor should be treated as continuing to own the interests he has given to these close relatives.

P. ANNUITY TREATMENT FOR DISTRIBUTIONS

As under present law and under the House bill, retirement benefits under your committee's bill, when paid to individuals as annuities under qualified plans would be taxable as ordinary income except to the extent that they have been financed by nondeductible contributions in which case benefits would be taxable under existing rules which allow individuals to recover their capital invested in a retirement contract free of tax.

Q. ESTATE AND GIFT TAX EXEMPTION

With respect to the estate and gift tax exemption in the case of retirement plan benefits, your committee's bill, like the House bill, does not change present law as it applies to ordinary employees, including owner-managers of corporations. However, the bill does not extend these exemptions to the self-employed (whether or not they are owner-employees) insofar as contributions were made to the plan by or for the individual while he was a self-employed person. The estate and gift tax exclusions will continue to apply with respect to any employer contributions made while the individual was not a self-employed person.

R. LUMP-SUM DISTRIBUTIONS

While your committee's bill does not extend to self-employed individuals (whether or not they are owner-employees) capital gains treatment on certain lump-sum distributions from retirement plans, such treatment is not denied to employees of the self-employed, who are treated in the same manner as employees of corporations. Under both the House bill and your committee's substitute, a self-employed individual will receive capital gains treatment on that portion of a lump-sum distribution which is attributable to any employer contributions made on his behalf while he was not a self-employed person. Capital-gain treatment is not allowed for lump-sum distributions derived from contributions as a self-employed person, but a special averaging device provides for the taxing of such lump-sum distributions received by self-employed individuals after age 59½ or received before age 59½ because of disability or death. Under the bill, the tax on such a distribution is five times the increase in tax resulting from adding 20 percent of such distribution to other taxable income, or by treating 20 percent of the distribution (reduced only by personal exemptions for the year) as taxable income. In this way some protection from the graduated rates of the individual income tax is given to those individuals who receive such a lump-sum distribution.

S. PROHIBITED TRANSACTIONS

The bill tightens the prohibited transaction rules of present law with respect to trusts forming part of pension plans covering owner-employees who control the business by means of a more than 50-percent ownership interest. Substantially identical rules were contained in the House bill. In these situations, since the owner-employee is, in effect, dealing with himself, your committee has pro-

vided that the owner-employee may not borrow from a trust he has established, may not buy from or sell property to that trust, and may not charge any fees for services he renders to the trust. It may be extremely difficult to review the activities of the large number of small trusts that may be established under this bill, and for these reasons your committee's bill prohibits owner-employees from engaging in any transaction with their own retirement trusts.

T. SUMMATION OF REQUIREMENTS FOR OWNER-EMPLOYEE PLANS

In summary, retirement plans covering owner-employees must meet the following requirements or qualifications in addition to those which present law requires of all retirement plans:

(1) If it is a trusteed plan, the trustee must be a bank or similar institution with fiduciary powers, but another person (who may be the employer) may be given power to control investments of the trust fund.

(2) In the case of owner-employees, benefits may not be payable before the owner-employee reaches age 59½, except in the case of severe disability or death, and benefit payments must begin before he reaches age 70½; in the case of self-employed individuals other than owner-employees, and employees of self-employed individuals benefits must be payable at age 70½ or retirement whichever is later Benefits in the foregoing cases may, under regulations, be payable over a period no longer than the life expectancy of the employee (including owner-employees) or the life expectancy of the employee and his spouse.

(3) In the case of plans of owner-employees with employees, contributions for employees must be nonforfeitable at the time they are made.

(4) In the case of a profit-sharing plan, a definite formula for determining employee contributions must be provided.

(5) Plans covering owner-employees must provide contributions for each full-time employee who has 3 years of employment.

(6) An owner-employee must consent to be covered by the plan.

(7) No excess contribution may be made.

(8) Where an owner-employee has employees, the plan may be coordinated with social security (under special rules) only if allowable contributions for him are not more than one-third of the total contributions made under the plan.

(9) If an owner-employee dies, his entire interest must within 5 years be (*a*) distributed to designated beneficiaries, (*b*) used to provide immediate annuities for them, or (*c*) paid out, under a plan of distribution already commenced, to a beneficiary over the life expectancy of the owner-employee or over the joint life expectancy of the owner-employee and his spouse.

(10) Excess contributions, if made, must be returned to the person who made them, and income earned by the plan which is attributable to the interest of an owner-employee with respect to whom an excess contribution was not timely returned must be taxed to the owner-employee.

(11) For purposes of qualifying the plan and determining what limitations are applied to contributions for owner-employees, two or

more businesses controlled by an owner-employee or by a group of owner-employees must be considered as a single business.

(12) Contributions on behalf of any owner-employee must be determined on the basis of his earned income from the trade or business with respect to which the retirement plan is established.

VII. Provisions of Bill Made Applicable to All Retirement Plans

Vesting on termination of plan; forfeiture.—The bill adds two new paragraphs to section 401(a) of the code which have the effect of codifying certain regulations and administrative practices of the Internal Revenue Service. These new paragraphs will apply to all pension plans, not merely those which cover self-employed persons, but because these practices have been in effect for many years, it is understood that no existing employee retirement plans would be invalidated by the addition of these rules to the statute.

The first of these new paragraphs requires that, upon termination of the plan or complete discontinuance of contributions thereto, the rights of all employees then covered by the plan must be nonforfeitable.

The second of these two new paragraphs imposed upon all retirement plans makes it plain that forfeitures of nonvested funds must not be used to increase the benefits any employee would otherwise receive under the plan.

Face amount certificates.—Under the bill nontransferable face amount certificates may in the future be purchased by nontrusteed retirement plans (including plans established by corporations). The present rules permit trustees to invest in such certificates, unless prohibited by local law. Because such certificates so closely resemble term-certain annuity contracts, your committee believes they should be permissible investments in the same manner as annuity contracts.

Nontransferable annuity contracts.—Your committee has added a provision to the bill under which annuity contracts issued under a qualified retirement plan after 1961 must be nontransferable, except where it is owned by a trustee of a qualified plan.

Custodial accounts.—Custodial accounts in a bank may be employed as a medium for funding qualified retirement plans of corporations, as well as plans covering self-employed persons. This provision of your committee's bill requires that funds in the custodial account must be invested either in stock of a regulated investment company or in annuity, endowment, or life insurance policies issued by an insurance company. This provision will enable many retirement plans to reduce their costs of administration since the bank will not have to perform the duties and accept the responsibilities of a trustee.

VIII. Miscellaneous Provisions of the Bill

The bill permits self-employed individuals to qualify for the retirement-income credit on the basis of distributions from qualified retirement plans. However, it does not permit self-employed persons to qualify either for the $5,000 death-benefit exclusion or for the sick-pay exclusion. Those provisions were enacted for the benefit of employees as contrasted to the self-employed and it is not the purpose of this bill to treat self-employed individuals as employees

except for retirement-plan purposes. However, the bill does allow a self-employed individual to exclude from his gross income under section 104 of the code amounts received through accident or health insurance for personal injuries or sickness, to the extent that such amounts are attributable to his own nondeductible contributions.

Where pension contributions take the form of the purchase of annuities, any loans against these contracts by an owner-employee are treated as distributions and any repayments of such loans are treated as contributions. In addition, if any portion of a trust or of a contract is assigned or pledged by an owner-employee that portion is also treated as a distribution from the trust or under the plan. Without these rules, an owner-employee could, in effect, obtain premature access to a substantial portion of the pension funds being accumulated for his retirement.

The bill makes it plain that the deduction for contributions made to a retirement plan by a self-employed individual on his own behalf may not be used to create or increase a net operating loss, and that owners of unincorporated businesses which elect to be taxed as corporations may participate in qualified retirement plans only in their capacity as self-employed persons. The bill also makes it clear that amounts contributed to a qualified retirement plan by a self-employed individual which are deductible, are treated as deductions from gross income in computing adjusted gross income. Thus, a self-employed individual may take this deduction and still qualify for the standard deduction.

IX. Technical Explanation

1. SECTION t. SHORT TITLE

The first section of the bill provides that the act may be cited as the "Self-Employed Individuals Tax Retirement Act of 1961."

2. SECTION t. QUALIFICATION OF PLANS

Section 2 of the bill amends section 401 of the Internal Revenue Code of 1954 to provide that self-employed individuals may be covered under qualified pension and profit-sharing plans. In addition, section 2 amends section 401 to add additional requirements which must be met in order for a trust forming part of a plan covering self-employed individuals who own more than 10 percent of the business to qualify under section 401. There are also added to section 401 two additional requirements which must be met by all qualified trusts and plans and one additional requirement which must be met by qualified trusts and plans covering self-employed individuals.

Section 401(a)

Existing section 401(a)(5) of the code provides that a plan shall not be considered discriminatory merely because the contributions or benefits under the plan bear a uniform relationship to the "total compensation, or the basic or regular rate of compensation," of the employees covered under the plan. Paragraph (1) of section 2 of the bill amends section 401(a)(5) to provide that, for purposes of that section and section 401(a)(10), the total compensation of a self-employed individual is such individual's earned income (as defined in sec. 401(c)(2)), and that the basic or regular rate of compensation of such

an individual is that portion of his earned income which bears the same ratio to his total earned income as the basic or regular compensation of the employees (other than self-employed individuals) benefited under the plan bears to their total compensation. This ratio is to be computed in accordance with regulations prescribed by the Secretary or his delegate.

Existing section 401(a) of the code sets forth the requirements which a pension, profit-sharing, or stock bonus trust must meet in order to constitute a qualified trust. Paragraph (2) of section 2 of the bill adds additional requirements (new pars. (7) to (10), inclusive).

The new paragraph (7) of section 401(a) provides that a trust will not qualify unless the plan of which it is a part provides that, upon its termination or upon complete discontinuance of contributions under the plan, each employee benefited under the plan will have an immediate vested right to so much of his benefits under the plan as have accrued and have been funded at the time of the termination or discontinuance or, in the case of a money purchase plan, will have an immediate vested right to the amounts credited to his account as of the date of the termination or discontinuance. This provision is not to be applicable, however, to benefits or contributions which, pursuant to regulations prescribed by the Secretary or his delegate to preclude discrimination, may not be used for designated employees in the event of early termination of the plan. For example, this provision would not require vesting when certain officers or highly compensated employees are, at the inception of the plan, within a few years of retirement age and the granting of vested rights to such employees upon termination of the plan shortly after they reach retirement age would result in the plan being discriminatory in favor of such officers or highly compensated employees.

The new paragraph (8) of section 401(a) provides that a trust forming part of a pension plan will not qualify unless the plan of which it is a part provides that forfeitures must not be applied to increase the benefits any employee would otherwise receive under the plan. Therefore, if the plan calls for future contributions, the forfeitures must be used to reduce such contributions.

The new paragraph (9) of section 401(a) provides that, in the case of a plan which provides contributions or benefits for employees some or all of whom are employees within the meaning of section 401(c)(1), a trust will not qualify unless, under the plan of which it is a part, the entire interest of each employee either (A) will be distributed to him not later than his taxable year in which he attains the age of 70½ years, or, in the case of an employee other than an owner-employee (as defined in sec. 401(c)(3)), in which he retires, whichever is the later, or (B) will be distributed, commencing before the close of such taxable year, (i) over the life of such employee or over the lives of such employee and his spouse, or (ii) over a period not extending beyond the life expectancy of such employee or over the life expectancy of such employee and his spouse. For these purposes, the Secretary or his delegate is to issue regulations prescribing the specific conditions under which these requirements will be considered to be met.

The new paragraph (10) of section 401(a) provides that, in the case of a plan which provides contributions or benefits for any owner-employee (as defined in sec. 401(c)(3))—

Section 401(a)(3) and the first and second sentences of section 401(a)(5) shall not apply, but—

(i) such plan shall not be considered discriminatory within the meaning of section 401(a)(4) merely because the contributions or benefits of or on behalf of employees under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of such employees, and

(ii) such plan shall not be considered discriminatory within the meaning of section 401(a)(4) solely because under the plan contributions described in section 401(e)(3)(A) which are in excess of the amounts which may be deducted under section 404 (determined without regard to sec. 404(a)(10)) for the taxable year may be made on behalf of any owner-employee.

In addition, subparagraph (B) of the new section 401(a)(10) provides that a trust forming part of a plan covering a self-employed individual owning more than a 10-percent interest in the business must, in order to qualify under section 401, also meet the new requirements of section 401(d).

Section 401(c)

Paragraph (3) of section 2 of the bill adds a new subsection (c) to section 401(a) of the code, which contains certain definitions and rules relating to self-employed individuals and owner-employees.

(1) *Definition of "employee."*—Under the present law, a qualified plan can cover only those individuals who are employees under common law. Paragraph (1) of the new subsection (c) defines the term "employee" to include, for any taxable year, a self-employed individual who has earned income (as defined in sec. 401(c)(2)) for the taxable year.

To the extent provided by regulations of the Secretary or his delegate, the term "employee" also includes, for any taxable year—

(A) an individual who would be an employee within the meaning of the first sentence of section 401(c)(1) but for the fact that the trade or business carried on by such individual did not have net profits for the taxable year, and

(B) an individual who has been an employee within the meaning of the first sentence of section 401(c)(1) for any prior taxable year.

(2) *Definition of "earned income."*—Paragraph (2) of the new subsection (c) contains a definition of "earned income." Subparagraph (A) provides that such term means the net earnings from self-employment (as defined in sec. 1402(a)) to the extent that such net earnings constitute earned income as defined in section 911(b) but determined with the application of subparagraph (B) of the new subsection (c)(2), but such net earnings and earned income shall be determined with certain modifications. The first of these modifications provides that doctors and certain ministers, who are not subject to the tax on self-employment income, shall be treated, for this purpose, as being engaged in a trade or business from which net earnings from self-employment are derived. The second modification provides that certain individuals described in section 3121(d)(3) who are not employees but who are not subject to the tax on self-employment income shall be

similarly treated. The third modification provides that amounts which are not otherwise includible in gross income shall not be included in an individual's net earnings from self-employment.

Subparagraph (B) of the new subsection (c)(2) provides that, in applying section 911(b) of the code for purposes of determining the "earned income" of a self-employed individual who is engaged in a trade or business in which both personal services and capital are material income-producing factors and with respect to which the individual actually renders personal services on a full-time, or substantially full-time, basis, so much of his share of the net profits of such trade or business as does not exceed $2,500 shall be considered as earned income. Such subparagraph (B) also provides that, in the case of any such individual who is engaged in more than one trade or business with respect to which he actually renders substantial personal services, if with respect to all such trades or businesses he actually renders personal services on a full-time, or substantially full-time, basis, there shall be considered as earned income with respect to the trades or businesses in which both personal services and capital are material income-producing factors (A) so much of his share of the net profits of such trades or businesses as does not exceed $2,500 reduced by (B) his share of the net profits of any trade or business in which only personal services is a material income-producing factor. When a self-employed individual is engaged in two or more trades or businesses in which both personal services and capital are material income-producing factors, the $2,500 must be allocated among such trades or businesses, but in no case shall the individual be considered to have earned income from a trade or business in excess of his share of the net profits of such trade or business.

Section 911(b) provides that, in the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, such individual's earned income from such trade or business shall not exceed 30 percent of his share of the net profits of such trade or business. Subparagraph (B) provides that its provision shall not be construed to reduce the amount of an individual's earned income below that which he would be considered to have under section 911(b). The application of subparagraph (B) may be illustrated by the case of an individual who is engaged on a full-time basis in a trade or business in which both personal services and capital are material income-producing factors and whose net profits from the trade or business for the taxable year are $6,000. Under section 911(b), such individual would be presumed to have received not more than $1,800 of earned income from such trade or business (30 percent times $6,000). However, under subparagraph (B) such individual is considered to have received $2,500 of earned income from such trade or business.

(3) *Definition of "owner-employee."*—Certain of the provisions of the bill are applicable only to owner-employees or to plans covering owner-employees. Paragraph (3) of the new subsection (c) defines the term "owner-employee" to mean an employee who—

(A) owns the entire interest in an unincorporated trade or business, or

(B) in the case of a partnership, is a partner who owns more than 10 percent of either the capital interest or the profits interest in such partnership.

To the extent provided in regulations prescribed by the Secretary or his delegate, the term owner-employee also means an individual who has been an owner-employee within the meaning of section 401(C)(3).

(4) *Definition of "employer."*—In order to qualify under section 401, a plan must be a plan of an employer. Paragraph (4) of the new subsection (c) provides that, for this purpose, an individual who owns the entire interest in an unincorporated trade or business shall be treated as his own employer. Similarly, a partnership shall be treated as the employer of its partners.

(5) *Rules of constructive ownership.*—Paragraph (5) of the new subsection (c) provides rules of constructive ownership for determining who is an owner-employee and for determining in certain other situations an individual's ownership interest. Under such paragraph (5), an individual shall be treated as owning any interest in an unincorporated trade or business which is owned, directly or indirectly, by his spouse or minor children. This rule is applicable whether or not such individual himself owns any interest in the trade or business. In addition, when an individual owns any interest in an unincorporated trade or business or is an employee of such trade or business, he shall also be treated as owning any interest in such unincorporated trade or business, which is owned, directly or indirectly, by his ancestors or by his lineal descendants. Paragraph (5) provides, however, that any interest treated as owned by any individual by reason of such paragraph shall not be treated as owned by him for the purpose of applying such paragraph in order to make any other individual the constructive owner of such interest. For the purpose of paragraph (5), a legally adopted child or an individual is treated as a child of such individual by blood.

Section 401(d)

Paragraph (3) of section 2 of the bill also adds a new subsection (d) to section 401, which sets forth additional requirements which must be met in order for a trust-forming part of a pension or profit-sharing plan providing contributions or benefits for any owner-employees to qualify under section 401.

(1) *Trustee must be a bank.*—Paragraph (1) of the new subsection (d) provides that, in the case of a trust which is created on or after the date of the enactment of the bill, or which was created before such date but is not exempt as a qualified trust on the day before such date, the trustee must be a bank. However, paragraph (1) provides that a person (including the employer) other than a bank may be granted, under the trust instrument, the power to direct the investment of the trust funds. Paragraph (1) is not applicable to a trust created or organized outside the United States before the date of the enactment of the bill if, under section 402(c), such trust is treated as exempt from tax under section 501(a) on the day before such date. Such paragraph (1) defines the term "bank" to mean (A) a bank as defined in section 581, and (B) a corporation which under the laws of the State of its incorporation is subject to supervision and examination by the commissioner of banking or similar officer, and (C) in the case of a foreign trust, a bank or trust company, wherever incorporated, exercising fiduciary powers and subject to supervision and examination by governmental authority.

(2) *Vesting.*—Paragraph (2)(A) of the new subsection (d) provides that, in the case of a plan which provides contributions or benefits for employees some or all of whom are owner-employees, each employee's rights to or derived from the contributions under the plan must be nonforfeitable at the time such contributions are paid to or under the plan. The requirement of vesting shall not apply to contributions which, under provisions of the plan adopted pursuant to regulations prescribed by the Secretary or his delegate to preclude the discrimination prohibited by section 401(a)(4), may not be used to provide benefits for designated employees in the event of early termination of the plan.

(3) *Profit-sharing plans.*—Paragraph (2)(B) of the new subsection (d) also provides that in the case of a profit-sharing plan which provides contributions or benefits for employees some or all of whom are owner-employees, there must be a definite formula for determining contributions to be made to the trust by the employer on behalf of employees other than owner-employees.

(4) *Required coverage.*—Paragraph (3) of the new subsection (d) provides that, in the case of a plan which provides contributions or benefits for an owner-employee who owns more than 10 percent of the business, the trust forming a part of such plan shall constitute a qualified trust under section 401 only if such plan benefits each employee having a period of employment of 3 years or more. For the purpose of determining whether an individual is an employee for whom a covered owner-employee is required to provide benefits, the new paragraph (3) provides that the term "employee" does not include any employee whose customary employment is for not more than 20 hours in any one week or is for not more than 5 months in any calendar year.

(5) *Consent to being included.*—Paragraph (4)(A) of the new subsection (d) provides that, under the plan, contributions or benefits must not be provided for any owner-employee unless such owner-employee has consented to being included under the plan.

(6) *Time of distribution.*—Paragraph (4)(B) of the new subsection (d) provides that, under the plan, no benefits may be paid to any owner-employee, except in the case of his disability (within the meaning of sec. 213(g)(3)), prior to his attaining age 59½.

(7) *Contributions for owner-employees.*—Paragraph (5) of the new subsection (d) provides that the plan must not permit—

(A) contributions to be made by an employer for any owner-employee in excess of the amounts which may be deducted under section 404 (determined without regard to sec. 404(a)(10)) for the taxable year;

(B) in the case of a plan which covers only owner-employees, contributions to be made on behalf of any owner-employee in excess of those which are deductible under section 404 (without regard to sec. 404(a)(10)) for the taxable year (i.e., contributions by an owner-employee in his capacity as an employee may not be made); and

(C) if a distribution under the plan is made to any owner-employee before such owner-employee attains the age of 59½ or becomes disabled, contributions to be made on behalf of such owner-employee for the 5 taxable years succeeding the taxable year in which such distribution is made.

Such paragraph (5) also provides that subparagraphs (A) and (B) shall not apply to any contribution which is excepted from the definition of excess contribution contained in section 401(e)(1) by reason of the application of section 401(e)(3).

(8) *Coordination with social security.*—Paragraph (6) of the new subsection (d) provides that a plan providing contributions or benefits for any owner-employee must, except as otherwise provided in such paragraph (6), satisfy the requirements of section 401(a)(4) without taking into account, for any purpose, contributions or benefits under chapter 2 (relating to the tax on self-employment income), chapter 21 (relating to Federal Insurance Contributions Act), title II of the Social Security Act, as amended, or any other Federal or State law. Such paragraph (6) further provides that, if—

(A) of the contributions deductible under section 404 (determined without regard to sec. 404(a)(10)) for the taxable year, not more than one-third is deductible by reason of contributions by the employer for owner-employees; and

(B) taxes paid by the owner-employees under chapter 2 (relating to tax on self-employment income), and the taxes which would be payable under such chapter 2 by the owner-employees but for paragraphs (4) and (5) of section 1402(c), are taken into account as contributions by the employer on behalf of such owner-employees,

then taxes paid under section 3111 (relating to tax on employers) with respect to an employee may, for purposes of section 401(a)(4) be taken into account as contributions by the employer for such employee under the plan.

(9) *Distribution after death.*—Under paragraph (7) of the new subsection (d), the plan must provide that, after the death of an owner-employee, his remaining interest in the plan must be either distributed to his beneficiary within 5 years, or used within that period to purchase an immediate annuity for his beneficiary which will be distributed immediately to such beneficiary or beneficiaries. A similar rule is provided if distribution of the interest of an owner-employee has been commenced to his surviving spouse, and the surviving spouse dies before the entire interest is distributed. However, such paragraph (6) shall not apply if distribution of the interest of an owner-employee has commenced and such distribution is for a term certain over a period permitted under section 401(a)(9)(B)(ii).

(10) *Repayment of excess contributions.*—Paragraph (8) of the new subsection (d) provides that, under the plan—

(A) any excess contribution, together with the income attributable thereto, is (except in the case of a willfully made excess contribution) to be repaid to the owner-employee on whose behalf such excess contribution was made;

(B) if for any taxable year the plan does not, by reason of section 401(e)(2)(A), meet (for purposes of sec. 404) the requirements of section 401(d) with respect to an owner-employee, the income for the taxable year attributable to the interest of such owner-employee under the plan is to be paid to such owner-employee; and

(C) the entire interest of an owner-employee is to be repaid to him, when required by section 401(e)(2)(E) (relating to willful excess contributions).

(11) *Control of more than one trade or business.*—Paragraph (9)(A) of the new subsection (d) provides that, if the plan provides contributions or benefits for an owner-employee who controls, or two or more owner-employees who together control, the trade or business with respect to which the plan is established, and who also control as an owner-employee or as owner-employees one or more other trades or businesses, such plan and the plans established by such other trades or businesses must constitute one overall plan which meets the requirements of section 401 (a) (including the new paragraph (10) of section 401(a) and section 401(d)), with respect to the employees of all such trades or businesses.

Paragraph (9)(B) of the new subsection (d) provides that an owner-employee, or two or more owner-employees, shall be considered to control a trade or business if such owner-employee, or such two or more owner-employees together—

(i) own the entire interest in an unincorporated trade or business, or

(ii) in the case of a partnership, own more than 50 percent of either the capital interest or the profits interest in such partnership.

For purposes of determining his ownership interest, an owner-employee, or two or more owner-employees, shall be treated as owning any interest in a partnership which is owned, directly or indirectly, by a partnership which such owner-employee, or such two or more owner-employees, are considered to control within the meaning of paragraph (9)(B).

(12) *Owner-employee benefited under more than one plan.*—Paragraph (10) of the new subsection (d) provides that a plan must not provide contributions or benefits for any owner-employee who controls (within the meaning of sec. 401(d)(9)(B)), or for two or more owner-employees who together control, as an owner-employee or as owner-employees, any other trade or business, unless the employees of each trade or business which such owner-employee or such owner-employees control are included under a plan which satisfies the requirements of section 401(a) (including sec. 401(a)(10)) and section 401(d), and provides contributions and benefits for employees which are not less favorable than contributions and benefits provided for owner-employees under the plan.

The application of such paragraph (10) may be illustrated by the following example:

Example.—X, a self-employed individual, is a 15 percent partner in the XYZ partnership and is the owner of the P company, a sole proprietorship. The pension plan of the XYZ partnership must not provide contributions or benefits for X unless the employees of the P company are included under a pension plan of that company which satisfies the requirements of section 401(a) (including sec. 401(a)(10)) and section 401(d), and which provides contributions and benefits for employees which are not less favorable than contributions and benefits provided for X under the plan of the XYZ partnership. This requirement must be met whether or not X is included under the plan of the P company.

(13) *Contributions limited to the earned income from the trade or business.*—Paragraph (1) of the new subsection (d) provides that, under the plan, contributions on behalf of any owner-employee may

be made only with respect to the earned income of such owner-employee derived from the trade or business with respect to which the plan is established.

Section 401(e)

Paragraph (3) of section 2 of the bill adds a new subsection (e) to section 401, which contains a definition of "excess contribution" and which sets forth the consequences of making such an excess contribution. For the purpose of determining whether an excess contribution has been made on behalf of any owner-employee in a taxable year, there must be taken into account all other contributions made on behalf of such owner-employee for such taxable year.

(1) *Definition of "excess contribution".*—Paragraph (1) of the new subsection (e) defines the term "excess contribution" for purposes of section 401. Except as otherwise provided in section 401(e)(3), the term "excess contribution" means—

(A) if, in the taxable year, contributions are made under the plan only on behalf of owner-employees, so much of any contribution made on behalf of any owner-employee as is not deductible under section 404 (determined without regard to sec. 404(a)(10)) for the taxable year; or

(B) if, in the taxable year, contributions are made under the plan on behalf of both owner-employees and other employees—

(i) so much of any contribution made by an employer on behalf of any owner-employee as is not deductible under section 404 (determined without regard to sec. 404(a)(10)) for the taxable year;

(ii) so much of any contribution as is made by an owner-employee (as an employee) at a rate which exceeds the rate of contributions permitted to be made by employees other than owner-employees;

(iii) so much of any contributions made by an owner-employee (as an employee) as exceeds the lesser of $2,500 or 10 percent of the earned income for such taxable year derived by such owner-employee from the trade or business with respect to which the plan is established;

(iv) in the case of any individual on whose behalf contributions are made under more than one plan as an owner-employee, the amount of any contribution made by such owner-employee (as an employee) under all such plans which exceeds $2,500; and

(C) any contribution made on behalf of an owner-employee in any taxable year for which, under section 401(e)(2)(A) or (E), the plan does not (for purposes of sec. 404) meet the requirements of section 401(d) with respect to such owner-employee.

Such paragraph (1) provides, however, that the amount of any contribution which is allocable (determined in accordance with regulations prescribed by the Secretary or his delegate) to the purchase of life, accident, health, or other insurance shall not be taken into account in determining the amount of any contribution for purposes of determining whether such contribution is an excess contribution.

(2) *Effect of excess contribution.*—Paragraph (2)(A) of the new subsection (e) provides that, if an excess contribution (other than a willful excess contribution to which sec. 401 (e)(2)(E) applies) is made

on behalf of an owner-employee in any taxable year, the plan with respect to which such excess contribution is made shall, except as provided in section 401(e) (2) (C) and (D), be considered, for purposes of section 404, as not meeting the requirements of section 401(d) with respect to such owner-employee for the taxable year and for all succeeding taxable years. In any year when an otherwise exempt trust forming part of a plan is (pursuant to par. (2)(A)) considered, for purposes of section 404, as not meeting the requirements of section 401(d) with respect to an owner-employee, the earnings of such trust (including those attributable to the interest of the owner-employee with respect to whom the excess contribution was made) shall remain exempt from tax in the hands of the trust. However, the trust shall not be considered exempt for purposes of deducting any contributions made on behalf of the owner-employee with respect to whom the excess contribution was made.

Paragraph (2)(B) of the new subsection (e) provides that, for any taxable year for which a plan does not meet the requirements of section 401(d) with respect to an owner-employee by reason of paragraph (2)(A), such owner-employee shall currently include in his gross income the income for such year attributable to his interest in the plan.

Paragraph (2)(C) of the new subsection (e) provides that paragraph (2)(A) (and, consequently, par. (2)(B)) shall not apply to an excess contribution with respect to any taxable year if (on or before the close of the 6-month period beginning on the day on which the Secretary or his delegate sends by certified or registered mail, to the trust, insurance company, or other person to whom such excess contribution was paid, notice of the amount of such excess contribution) the amount of such excess contribution, and the income attributable thereto, is repaid to the owner-employee on whose behalf such excess contribution was made. Such paragraph (2)(C) further provides that, if the contribution is an excess contribution by reason of exceeding the deduction limitations under section 404, the notice required to be sent by the Secretary or his delegate shall not be mailed prior to the time that the amount of the tax under chapter 1 of the Internal Revenue Code of the owner-employee to whom the excess contribution is to be repaid has been finally determined for the taxable year in which such excess contribution was made.

Paragraph (2)(D) of the new subsection (e) provides that, if an excess contribution, together with the income attributable thereto, is not repaid within the 6-month period, paragraph (2)(A) shall not apply to any taxable year beginning with the taxable year in which the trust, insurance company, or other person to whom such excess contribution was paid repays the amount of such excess contribution to the owner-employee on whose behalf such excess contribution, and also pays to the owner-employee with respect to whom the excess contribution was made the amount of income attributable to the interest of such owner-employee which, under paragraph (2)(B), is required to be included in such owner-employee's gross income for any prior taxable year.

(3) *Special rule if excess contribution was willfully made.*—Paragraph (2)(E) of the new subsection (e) provides that, if an excess contribution made on behalf of an owner-employee is determined to have been willfully made, then, instead of applying the provisions of section 401(e)(2) (A), (B), (C), and (D)—

(i) there shall be distributed to the owner-employee on whose behalf such excess contribution was willfully made his entire interest in all plans in which he is a participant as an owner-employee; and

(ii) contributions may not be made on behalf of such owner-employee to any plan in which he is a participant as an owner-employee for the taxable year in which it is determined that such excess contribution was willfully made and for the 5 taxable years following such taxable year.

Thus, when it has been determined that an excess contribution has been willfully made to a plan on behalf of an owner-employee, such owner-employee's entire interest in all plans in which he is a participant as an owner-employee must be distributed to him and he may not participate in any plan with respect to which he is an owner-employee for the taxable year of the determination and for the 5 succeeding taxable years.

(4) *Statute of limitations.*—Paragraph (2)(F) of the new subsection (e) provides that, in any case in which a plan does not meet the requirements of section 401(d) with respect to an owner-employee by reason of paragraph (2)(A), the period for assessing any deficiency arising by reason of—

(i) the disallowance of any deduction under section 404 because such plan does not meet the requirements of section 401(d) with respect to an owner-employee on whose behalf an excess contribution was made, or

(ii) the inclusion, under paragraph (2)(B), in gross income of such owner-employee of the income attributable to his interest under a plan,

for the taxable year in which such excess contribution was made or for any succeeding taxable year shall not expire prior to 1 year after the close of the 6-month period referred to in pargraph (2)(C).

(3) *Contributions for premiums on annuity, etc., contracts.*—Paragraph (3) of the new subsection (e) provides for certain exceptions to the definition of an "excess contribution" in section 401(e)(1). Such paragraph (3) provides that a contribution by an employer on behalf of an owner-employee shall not be considered to be an excess contribution within the meaning of section 401(e)(1), if—

(A) under the plan such contribution is required to be applied (directly or through a trustee) to pay premiums or other consideration for one or more annuity, endowment, or life insurance contracts issued under the plan on the life of such owner-employee, and

(B) the amount of such contribution exceeds the amount deductible under section 404 with respect to contributions made by the employer on behalf of such owner-employee; and

(C) the amount of such contribution does not exceed the average of the amounts which were deductible under section 404 (determined without regard to sec. 404(a)(10)) with respect to contributions made by the employer on behalf of such owner-employee (or which would have been deductible if section 404 had been in effect for prior years) for the first 3 taxable years (i) preceding the year in which the last such annuity, endowment, or life insurance contract was issued under the plan, and (ii) in which such owner-employee derived earned income from the trade

or business with respect to which the plan is established, or for so many of such taxable years as such owner-employee was engaged in such trade or business and derived earned income therefrom.

The new paragraph (3) also provides that, in the case of any individual on whose behalf contributions described in the new paragraph (3)(A) are made under more than one plan as an owner-employee during any taxable year, the amount of contributions to which the new paragraph (3) applies for such taxable year must not exceed $2,500. Thus, if the premiums or other consideration for annuity contracts paid on behalf of an owner-employee under more than one plan from contributions made by employees exceed $2,500, the excess contributions rules of sections 401(e) (1) and (2) apply to all such contributions on behalf of such owner-employee for such taxable year. Furthermore, any contribution which is not considered to be an excess contribution by reason of the application of the provisions of section 401(e)(3) shall, for purposes of section 401(e)(1)(B) (ii), (iii), and (iv), be taken into account as a contribution made on behalf of such owner-employee as an employee to the extent that the amount of such contribution is not deductible under section 404 (without regard to section 404(a)(10)) for the taxable year, but only for the purpose of applying such sections to other contributions made on behalf of such owner-employee as an employee.

Section 401(f)

Under the present law, section 401(a) of the code relates only to trusts which form part of pension, profit-sharing, and stock-bonus plans. Paragraph (3) of section 2 of the bill also adds a new subsection (f) to section 401(a), which permits certain custodial accounts to qualify under section 401(a) if they form a part of qualified plans. Under the new subsection (f), a custodial account shall be treated as a qualified trust, if—

(1) such custodial account satisfies all the requirements which must be satisfied by a qualified trust;

(2) the custodian is a bank (as defined in section 401(d)(1));

(3) the investment of the funds in such account (including all earnings) is to be made either solely in regulated investment company stock with respect to which an employee is the beneficial owner (treating as subject to this requirement all capital gain dividends and any refund to the custodian under section 852(b)(3)(D)(ii) of the code), or solely in annuity, endowment, or life insurance contracts issued by an insurance company;

(4) in the case of investments in regulated investment company stock, the custodian or its nominee is the shareholder of record of all stock held in the account; and

(5) in the case of annuity, endowments, or life insurance contracts, the contracts are held by the custodian until distributed under the plan.

For purposes of the code, in the case of a custodial account treated as a qualified trust under section 401 by reason of the new section 401(f), the custodian of such account is to be treated as the trustee thereof.

Paragraph (2) of the new subsection (f) defines "regulated investment company" to mean a domestic corporation (A) which is a regulated investment company within the meaning of section 851(a), and (B) which issues only redeemable stock.

Section 401(g)

Paragraph (3) of section 2 of the bill also adds a new subsection (g) to section 401 which provides that, for purposes of sections 401, 402, 403, and 404, the term "annuity" includes a face-amount certificate as defined in section 2(a)(15) of the Investment Company Act of 1940 (15 U.S.C. 80a–2); but does not include any contract or certificate issued after December 31, 1961, which is transferable, if any person other than the trustee of a qualified trust is the owner of such contract or certificate.

SECTION 3. DEDUCTIBILITY OF CONTRIBUTIONS TO PLANS

Section 3 of the bill amends section 404 of the Internal Revenue Code of 1954 to allow the deductions for certain amounts of contributions made on behalf of self-employed individuals who are covered under qualified pension, annuity, and profit-sharing plans. In addition, section 404 is amended to provide additional limitations on the amount that may be deducted with respect to contributions on behalf of self-employed individuals.

Section 404(a)

(1) *Annuity plans.*—Section 404(a)(2) allows, within the applicable limitations, the deduction of employer contributions paid toward the purchase of retirement annuities if such purchase is a part of a plan which meets the requirements of section 401(a) (3), (4), (5), and (6), and if certain other conditions are met. Subsection (a)(1) of section 3 of the bill amends section 404(a)(2) to provide that the annuity plan must, in addition to meeting the present requirements, also meet the requirements in the new paragraphs (7), (8), and (9) of section 401(a) and, if the plan benefits owner-employees, the requirements of the new sections 401(a)(10) and 401(d) (other than section 401(d)(1). Thus, a qualified annuity plan is, in general, subject to the same requirements as is a qualified pension, profit-sharing, or stock-bonus trust.

(2) *Inclusion of self-employed.*—Subsection (a)(2) of section 3 of the bill adds a new paragraph (8) to section 404(a), which allows the deduction under section 404(a) of contributions to a qualified, plan covering self-employed individuals. To accomplish this purpose the new paragraph (8) provides that, for purposes of applying section 404 to a qualified pension, annuity, or profit-sharing plan covering self-employed individuals—

(A) the term "employee" is defined to include a self-employed individual who is an employee within the meaning of section 401(c)(1), and the employer of such a self-employed individual is defined to mean the person treated as his employer under section 401(c)(4);

(B) the term "earned income" has the meaning assigned to it by section 401(c)(2);

(C) the contributions to such a plan on behalf of a self-employed individual shall be considered to satisfy the conditions of section 162 or section 212 to the extent that such contributions do not exceed the earned income (as defined in sec. 401(c)(2) of such individual derived from the trade or business with respect to which such plan is established. However, contributions on

behalf of self-employed indivuduals which are allocable (determined in accordance with regulations prescribed by the Secretary or his delegate) to the purchase of life, accident, health, or other insurance are not considered to satisfy the conditions of section 162 or section 212 and, therefore, are not deductible under section 404; and

(D) all references in section 404 to the term "compensation" shall, in the case of a self-employed individual, be considered a reference to the earned income (as defined in sec. 401(c)(2)) of such individual derived from the trade or business with respect to which the plan is established.

(3) *Plans benefiting owner-employees.*—Subsection (a)(2) of section (3) of the bill adds a new paragraph (9) to section 404(a), which provides special rules for computing the limitations on the amounts deductible for contributions under a qualified pension, annuity, or profit-sharing plan covering owner-employees.

Subparagraph (A) of the new paragraph (9) provides that the limitations in paragraphs (1), (2), (3), and (7) of section 404(a) shall be computed, with respect to employees (other than owner-employees), as if such employees were the only employees for whom contributions or benefits are provided under the plan. For example, if a qualified profit-sharing plan covers both owner-employees and other employees, the amount deductible under section 404(a)(3) with respect to contributions on behalf of such other employees is 15 percent of the compensation paid to such other employees if there are no carryovers for such year.

Subparagraph (B) of the new paragraph (9) provides that the limitations in paragraphs (1), (2), (3), and (7) of section 404(a) with respect to contributions under a qualified plan on behalf of owner-employees, shall be computed—

(i) as if such owner-employees are the only employees for whom contributions or benefits are provided under the plan; and

(ii) without regard to the carryover provisions contained in section 404(a)(1)(D), the second and third sentences of section 404(a)(3), and the second sentence of section 404(a)(7).

Subparagraph (C) of the new paragraph (9) provides that the amounts which are otherwise deductible under section 404(a) with respect to contributions on behalf of an owner-employee shall not exceed the additional limitations provided in section 404(e).

The new paragraph (9) further provides that, for purposes of section 404, the term "owner-employee" has the meaning assigned to it by section 401(c)(3) (determined with the application of the rules of constructive ownership contained in sec. 401(c)(5)).

(4) *Special limitation on amount allowed as a deduction for self-employed individuals.*—Subsection (a)(2) of section 3 of the bill adds a new paragraph (10) to section 404(a), which provides a special limitation on the amount allowable as a deduction under sections 404(a)(1), (2), (3), and (7) in any taxable year with respect to contributions made on behalf of any individual who is an employee within the meaning of section 401(c)(1).

The new paragraph (10) provides that, notwithstanding any other provision of section 404, in the case of any individual who is an employee within the meaning of section 401(c)(1), the amount allowable as a deduction is equal to—

(1) so much of the contributions made on behalf of such individual which are deductible under sections 404(a) (1), (2), (3), and (7) (determined without regard to the new paragraph (10)) as does not exceed $1,000, plus

(2) one-half of so much of the contributions made on behalf of such individual which are deductible under such sections as exceeds $1,000.

The new paragraph (10) further provides that, for purposes of section 401, the amount which may be deducted, or the amount deductible, under section 404, with respect to contributions made on behalf of a self-employed individual, shall be determined without regard to the new section 404(a)(10).

(5) *Interrelation of provisions of section 404(a).*—Section 404(a)(10) provides that any self-employed individual will be limited to a deduction of one-half of the amount in excess of $1,000 that would otherwise be deductible under section 404(a). The Provisions limiting the amount of otherwise deductible contributions are distinct from the provisions integrating the retirement plans of self-employed individuals into the structure of the present provisions of the code relating to qualified plans. Consequently, the special limitation in section 404(a)(10) is applied solely for the purpose of determining the amount which will be allowed as a deduction under section 404 for income tax purposes.

(6) *Determination of amount allowed as a deduction from gross income.*—In the case of self-employed individuals who are not owner-employees, the amount of the contributions made on their behalf which is deductible is determined by first applying to the applicable provisions of sections 404(a) (1), (2), and (3), and (7). Although there is no fixed maximum limitation the amount deductible under section 404(a), the new section 404(a)(8) provides that certain amounts contributed on behalf of self-employed individuals do not satisfy the requirements of sections 162 or 212 and are, therefore, not deductible under sections 404(a) (1), (2), or (3). The amounts to which the new section 404(a)(8) applies are contributions on behalf of self-employed individuals which exceed their earned income derived from the trade or business with respect to which the plan is established, and contributions which, under regulations prescribed by the Secretary or his delegate, are allocable to the purchase of life, accident, health, or other insurance. Finally, for the purpose of determining the amount which will be allowed as a deduction for income tax purposes, section 404(a)(10) is then applied.

In the case of owner-employees, the limitation in new section 404(e) is pertinent to the determination of the amount allowed as a deduction. Therefore, the discussion of the method of computing such amount is included with the discussion of the provisions of section 404(e).

Section 404(e)

Subsection (b) of section 3 of the bill adds to section 404 a new subsection (e), which provides additional limitations on amounts which may be deducted with respect to contributions on behalf of owner-employees.

(1) *Special limitations for owner-employees.*—Paragraph (1) of the new subsection (e) provides the additional limitations which are applicable in determining the amount that may be deducted with

respect to contributions under a qualified plan on behalf of owner-employees. Under paragraph (1), the amounts deductible under section 404(a) in any taxable year with respect to contributions on behalf of such owner-employees shall not exceed $2,500, or 10 percent of the earned income derived by such owner-employee from the trade or business with respect to which the plan is established, whichever is the lesser.

(2) *Overall limitation.*—Paragraph (2) of the new subsection (e) provides that in any taxable year in which amounts are deductible under two or more plans on behalf of an individual who is an owner-employee with respect to such plans, the aggregate amount deductible for such taxable year under all such plans with respect to contributions on behalf of such owner-employee shall not exceed $2,500. The overall limitation in paragraph (2) has no application with respect to contributions made under a plan on behalf of an employee who is not an owner-employee of the trade or business with respect to which the plan is established, even though such employee may be covered as an owner-employee under a plan or plans established by other trades or businesses.

Paragraph (2)(B) of the new subsection (e) provides that, in any case when paragraph (2)(A) reduces the amounts which are otherwise deductible under section 404 with respect to contributions made on behalf of an owner-employee under two or more plans, the portion of such reduced amount which is deductible under each plan shall be determined in accordance with regulations prescribed by the Secretary or his delegate.

(3) *Contributions allocable to insurance protection.*—Paragraph (3) of the new subsection (e) provides that the special limitations in section 404(e) are not applicable with respect to contributions which are allocable (determined under regulations prescribed by the Secretary or his delegate) to the purchase of life, accident, health, or other insurance.

(4) *Computation of amount allowed as a deduction from gross income in the case of owner-employees.*—If contributions are made on behalf of an owner-employee under a qualified plan, the provisions of the new section 404(a)(8) are applicable, and the computation of the amount deductible under sections 404(a)(1), (2), (3), and (7) is made in the manner prescribed in new section 404(a)(9). Furthermore, section 404(a)(9)(C) requires that the amount deductible, as so determined, must not exceed the applicable limitation in section 404(e). Section 404(e) places a ceiling on the amount deductible. That limit is 10 percent of the earned income of the owner-employee, or $2,500, whichever is the lesser. Finally, if the amount deductible as so determined exceeds $1,000, the special limitation of section 404(a)(10) provides that only one-half of such excess may be deducted.

Section 404(f)

Subsection (b) of section 3 of the bill adds to section 404 a new subsection (f), which provides that, for purposes of section 404, any amount paid, directly or indirectly, by an owner-employee in repayment of any loan on an insurance policy which, under section 72(m)(4)(B), was treated as an amount received under a contract shall be treated as a contribution to which section 404 (including the limitations therein) applies on behalf of such owner-employee.

SECTION 4. TAXABILITY OF DISTRIBUTIONS

Section 4 of the bill amends section 72 of the Internal Revenue Code of 1954 to provide rules for the taxation of amounts distributed under qualified plans for self-employed individuals or the beneficiaries of such individuals. In addition, section 4(b) adds a new subsection (m)(3) to section 72 of the code which applies to all qualified plans.

Section 72(d)

Existing section 72(d) of the code provides a special rule for the taxation of an annuity receivable by an employee when the aggregate amount receivable by the employee under the terms of the contract during the 3-year period beginning on the date on which the amount is first received under the contract as an annuity is equal to or greater than the consideration for the contract contributed by the employee. Subsection (a) of section 4 of the bill amends section 72(d)(2) to provide that, for purposes of section 72(d), any contribution which is made with respect to the contract while the employee is a self-employed individual but which is not allowed as a deduction under section 404 shall be treated as consideration for the contract contributed by the employee. This amendment merely makes clear that, as in the case of qualified plans established by corporations, a self-employed individual may not treat as consideration for the contract contributed by the employee any contributions under the plan for which deductions were allowed and which, consequently, are considered employer contributions. Moreover, under the new section 72(m)(2), described below, contributions on behalf of an owner-employee which are used to purchase life, accident, health, or other insurance are not, for purposes of section 72(d), included in the employee's basis for the contract.

Section 72(m)

Subsection (b) of section 4 of the bill adds to section 72 a new subsection (m), which provides special rules applicable to the taxation of employee annuities and distributions under employee plans.

(1) *Amounts received before annuity starting date.*—Paragraph (1) of the new subsection (m) provides that any amounts which are received under an annuity, endowment, or life insurance contract before the annuity starting date and which are not received as an annuity (within the meaning of sec. 72(e)(2)) shall be included in the recipient's gross income for the taxable year in which received to the extent that—

(A) such amounts, plus amounts theretofore received under the contract and includible in gross income under such paragraph (1), do not exceed

(B) the aggregate premiums or other consideration paid for the contract on behalf of an employee while such employee was an owner-employee (as defined in sec. 401(c)(3)) which were allowed as deductions under section 404 for the taxable year and all prior taxable years.

Such paragraph (1) further provides that any amounts received under an annuity, endowment, or life insurance contract before the annuity starting date which are not received as an annuity and which are not includible in gross income under such paragraph (1) shall be subject to the provisions of section 72(e).

The provisions of paragraph (1) may be illustrated by the example of a self-employed individual who receives $8,000 as a distribution under a qualified pension plan before the annuity starting date. At the time of such distribution, $10,000 had been contributed (the whole amount being allowed as a deduction) under the plan on behalf of such individual before he became an owner-employee and $5,000 had been contributed under the plan on his behalf while he was an owner-employee, of which $4,000 was allowed as a deduction. In addition, such individual had contributed $1,000 on his own behalf as an employee under the plan. Of the $8,000, $4,000 (the amount allowed as a deduction with respect to contributions on behalf of the individual while he was an owner-employee) is includible in gross income under paragraph (1). Of the remaining $4,000, $2,000 (the amount in excess of the sum of the portion of the contributions not allowed as a deduction by the employer and the amount contributed by the individual on his own behalf) is includible in gross income under section 72(e).

(2) *Computation of consideration paid by a self-employed individual.*—Paragraph (2) of the new subsection (m) provides that in computing—

(A) the aggregate amount of premiums or other consideration paid for the contract for purposes of section 72(c)(1)(A),

(B) the consideration for the contract contributed by the employee for purposes of section 72(d)(1), and

(C) the aggregate premiums or other consideration paid for purposes of section 72(e)(1)(B),

any amount allowed as a deduction with respect to the contract under section 404 while the employee was a self-employed individual shall be treated as consideration contributed by the employer. Such paragraph (2) further provides that the amounts described in paragraph (2) (A), (B), and (C) shall not include any portion of the premiums or other consideration for the contract paid while the employee was an owner-employee which is allocable (as determined under regulations prescribed by the Secretary of the Treasury or his delegate) to the cost of life, accident, health, or other insurance.

Paragraph (2) merely makes it clear that there shall not be included in an employee's, or in his beneficiary's, basis for a contract any amount which was contributed by such employee under a qualified plan and which was allowed as a deduction under section 404. In addition, under paragraph (2), there shall not be included in the basis of any contract the amount of any premiums or other consideration paid to purchase for an employee while he was an owner-employee any life, accident, health, or other insurance. Present law is to be applied in determining whether an amount to which paragraph (2) does not apply should be included in the basis of a contract.

(3) *Life insurance contracts.*—Paragraph (3) of the new subsection (m) is applicable to any life insurance contract—

(i) which is purchased as part of a qualified annuity plan described in section 403(a), or

(ii) which is purchased by a qualified trust, if the proceeds of such life insurance contract are payable directly or indirectly to a participant in such trust or to a beneficiary of such participant.

Paragraph (3)(B) provides that any contributions to such a qualified annuity plan or such a qualified trust allowed as a deduction under section 404, and any income of such a qualified trust, which are

determined (in accordance with regulations prescribed by the Secretary or his delegate) to have been applied to purchase the life insurance protection under a life insurance contract to which paragraph (3) applies are includible in the gross income of the employee for whom such protection is purchased for the taxable year when such contributions, or such income, are so applied. In the case of the death of an employee insured under a life insurance contract to which paragraph (3) applies, an amount equal to the cash surrender value of such contract immediately before the death of the employee shall be treated as a payment under the qualified plan or trust, and the excess of the amount payable by reason of the death of the insured over such cash surrender value shall not be includible in gross income under section 72 and shall be treated as provided in section 101. The provisions of paragraph (3) are rules presently contained in the regulations under the Internal Revenue Code of 1954.

(4) *Amounts constructively received.*—Paragraph (4)(A) of the new subsection (m) provides that, if during any taxable year an owner-employee assigns (or agrees to assign) or pledges (or agrees to pledge) any portion of his interest in a qualified trust or any portion of the value of a contract purchased as part of a qualified annuity plan, such portion shall be treated as having been received in such taxable year by such owner-employee as a distribution from such trust or as an amount received under such contract. Paragraph (4)(B) provides that, if during any taxable year an owner-employee receives, directly or indirectly, any amount from an insurance company as a loan under a contract purchased by a qualified trust or purchased as a part of a qualified annuity plan and issued by such insurance company, the amount of such loan is to be treated as an amount received under the insurance contract in such taxable year.

(5) *Penalties applicable to certain amounts received by owner-employees.*—Paragraph (5) of the new subsection (m) provides a penalty tax on certain amounts received by an owner-employee under a qualified trust or annuity plan. Paragraph (5)(A) provides that the penalty tax is applicable—

(i) to amounts (other than any amount received by an individual in his capacity as a policyholder of an annuity, endowment, or life insurance contract which is in the nature of a dividend or similar distribution) which are received under a qualified pension, annuity, or profit-sharing plan by an individual, who is, or has been, an owner-employee, before such individual attains the age of 59½, for any reason other than the individual's becoming disabled (within the meaning of sec. 213(g)(3) of the code), but only to the extent that such amounts are attributable to the contributions paid on behalf of such individual (whether or not paid by him) while he was an owner-employee;

(ii) to amounts which are received under such a qualified plan at any time by an individual who is, or has been, an owner-employee, or by the successor of such individual, but only to the extent that such amounts are determined, under regulations prescribed by the Secretary or his delegate, to exceed the benefits provided for such individual under the plan formula; and

(iii) to amounts which are received, by reason of the distribution under the provisions of section 401(e)(2)(E) (relating to willfully made excess contributions), by an individual who is, or

has been, an owner-employee of his entire interest in all such qualified plans.

The penalty tax is applicable to such amounts even though, at the time they are received, the recipient is not an owner-employee. In the case of an early distribution described in paragraph (5)(A)(i), the penalty tax is applicable to only so much of the distribution as is attributable to contributions paid on behalf of the recipient while he was an owner-employee. However, the penalty tax is applicable to the entire amount, to the extent it exceeds the benefits under the plan formula, received by an employee (or by the successor of an employee) who is, or has been, an owner-employee, even though a portion of such amount may be attributable to contributions made on behalf of such employee while he was not an owner-employee.

The penalty tax will, of course, apply only to amounts which would be includible in the recipient's gross income.

Paragraph (5)(B) provides that, if the aggregate of the amounts to which the penalty tax is applicable received by any person in his taxable year equals or exceeds $2,500, the increase in his tax for that taxable year attributable to the receipt of such amounts shall not be less than 110 percent of the aggregate increase in taxes, for that taxable year and the four immediately preceding taxable years, which would have resulted if such amounts had been included in such person's gross income ratably over such taxable years. If deductions had been allowed under section 404 for contributions paid on behalf of such person while he is an owner-employee for a number of prior taxable years less than 4, paragraph (5)(B)(i) shall be applied by taking into account the number of taxable years immediately preceding the taxable year in which the amount was so received equal to such lesser number.

Under paragraph (5)(C), if the aggregate of the amounts to which the penalty tax is applicable received by a person in his taxable year is less than $2,500, the increase in tax attributable to the receipt of such amounts shall be 110 percent of the increase computed without regard to this penalty tax.

paragraph (5)(D) provides that the penalty tax shall not apply to any amount (those amounts received with respect to contributions made on his behalf when he was not a self-employed individual) which is taxed, under section 402(a)(2) or section 403(a)(2), as capital gains. On the other hand, since a distribution required as a result of a determination that a willful excess contribution has been made on behalf of an owner-employee is not a distribution on account of separation from service or death, the penalty tax will, in all cases, be applicable to such a distribution.

Paragraph (5)(E) indicates that section 72(n)(3) is to be applied for purposes of computing the taxable income for taxable years to which paragraph (5) applies.

Paragraph (6) of the new subsection (m) provides that, for purposes of section 72, the term "owner-employee" has the meaning assigned to it by section 401(c)(3) (determined with the application of the attribution rules of section 401(c)(5)).

Section 72(n)

Subsection (b) of section 4 of the bill also adds to section 72 a new subsection (n), which provides special tax treatment with respect to

certain total distributions received under qualified plans which are attributable to contributions on behalf of self-employed individuals.

(1) Paragraph (1) of the new subsection (n) sets forth the distributions to which the special tax treatment in section 72(n) applies. In the case of a qualified pension or profit-sharing trust, the special tax treatment is applicable to amounts distributed to a distributee, if such amounts represent the total distributions payable to the distributee with respect to an employee and if such amounts are paid to the distributee within 1 taxable year of the distributee—

(i) on account of the employee's death,

(ii) after the employee has attained the age of 59½ years, or

(iii) after the employee has become disabled (within the meaning of section 213(g)(3) of the code).

In the case of a qualified annuity plan, the special tax treatment is applicable to amounts paid to a payee, if such amounts represent the total amounts payable to the payee with respect to an employee and if such amounts are paid to the payee within 1 taxable year of the payee—

(i) on account of the employee's death,

(ii) after the employee has attained the age of 59½ years, or

(iii) after the employee has become disabled (within the meaning of section 213(g)(3)).

For the special tax treatment to be applicable to a distributee or payee with respect to a distribution of an employee's interest in a qualified plan, it is not necessary that there also be distributed within the 1-year period any portion of the employee's interest which is payable to another payee or distributee.

The special tax treatment provided by the new section 72(n) is, under paragraph (1)(C), applicable only with respect to so much of any distribution or payment as is attributable to contributions made under a qualified plan on behalf of an employee within the meaning of section 401(c)(1). If an employee receives a distribution or payment of his own interest in a qualified plan or trust, the special tax treatment is applicable to such distribution or payment only if contributions which were allowed as a deduction under section 404 have been made on behalf of such employee while he was a self-employed individual for five or more taxable years prior to the taxable year in which such distribution is paid. In addition, the special tax treatment is not applicable to amounts to which the penalty tax in section 72(m)(5) is applicable.

(2) Paragraph (2) of the new subsection (n) provides that, in any case when the special tax treatment applies, the tax attributable to the amounts to which the new subsection (n) applies for the taxable year for which such amounts are received is not to exceed whichever of the following is the greater:

(A) five times the increase in tax which would result from the inclusion in gross income of the recipient of 20 percent of so much of the amount so received as is includible in gross income; or

(B) five time the increase in tax which would result if the taxable income of the recipient for such taxable year equaled 20 percent of the amount of the taxable income of the recipient for such taxable year determined under section 72(n)(3)(A).

(3) Paragraph (3) of the new subsection (n) provides that (notwithstanding sec. 63) for purposes only of computing the tax under chapter 1 of the Internal Revenue Code of 1954 attributable to

amounts to which the new subsection (n) or section 72(m)(5) (relating to the penalty tax in the case of certain distributions) applies and which are includible in gross income—

(A) the taxable income of the recipient for the taxable year of receipt is to be treated as being not less than the amount by which (i) the aggregate of such amounts so includible in gross income exceeds (ii) the amount of the deductions allowed for such taxable year under section 151 (relating to deductions for personal exemptions); and

(B) in making ratable inclusion computations under paragraph (5)(B) of section 72(m), the taxable income of the recipient for any taxable year involved in such ratable inclusion is to be treated as being not less than the amount required by such paragraph (5)(B) to be treated as includible in gross income for such taxable year.

In any case in which section 72(n)(3) results in an increase in taxable income for any taxable year, the resulting increase in the taxes imposed by section 1 or section 3 for such taxable year shall not be reduced by any credit under part IV of subchapter A of chapter 1 (other than sec. 31) of the Internal Revenue Code of 1954 which, but for this provision, would be allowable.

In no case is there subjected to tax under the penalty tax in section 72(m)(5) or the special tax treatment in section 72(n) amounts which represent a recipient's basis in the distribution.

The application of the rules in paragraph (3) of the new subsection (n) in the case of a total distribution to which the special tax treatment in the new section 72(n) applies may be illustrated by the following example: A, a sole proprietor, established a qualified pension trust to which he made annual contributions for 10 years of 10 percent of his earned income. A withdrew his entire interest in the trust during a taxable year for which, without regard to the distribution, he had a net operating loss and for which he is allowed under section 151 a deduction for one personal exemption. At the time of the withdrawal, A was 64 years old. The amount of the distribution that is includible in his gross income is $25,600. For purposes of determining the tax attributable to the $25,600, A's taxable income for the taxable year in which he received such amount is treated, under paragraph (3) of the new subsection (n), as being $25,000 ($25,600 minus $600 (the deduction allowed for his personal exemption)). Thus, under paragraph (2) of the new subsection (n), the tax attributable to the $25,600 would be five times the increase in tax which would result if the taxable income of A for the taxable year he received such amount equaled $5,000 (20 percent of his taxable income determined under paragraph (3) of the new subsection (n)).

The application of the rules in paragraph (3) of the new subsection (n) in the case of a distribution to which section 72(m)(5) applies may be illustrated by the following example: Assume the same facts as in the example in the preceding paragraph except that A was 55 years old (and not disabled) at the time of the withdrawal. In addition, A had a net operating loss for the taxable year immediately preceding the taxable year in which he received the $25,600. The other 3 taxable years involved in the computations under section 72(m)(5)(B) were years of substantial income. For purposes of determining A's increase in tax attributable to the receipt of the $25,600

(before the application of the spreading provisions in section 72(m)(5)(B)), A's taxable income for the year he received the $25,600 is treated, under paragraph (3)(A) of the new subsection (n), as being $25,000 ($25,600 minus $600). For purposes of determining whether 110 percent of the aggregate increase in taxes which would have resulted if 20 percent of the amount of the withdrawal had been included in A's gross income for the year of receipt and for each of the 4 preceding taxable years is greater (and thus is the amount of his increase in tax attributable to the receipt of the $25,600), A's taxable income for the taxable year of receipt, and for the immediately preceding taxable year, is treated, under paragraph (3)(B) of the new subsection (n), as being $5,120 ($25,600 divided by 5).

Section 402(a)

Existing section 402(a)(2) provides that certain total distributions from qualified trusts are taxable as capital gains. Subsection (c) of section 4 of the bill amends section 402(a)(2) to provide that the capital gains treatment is not applicable to distributions paid to any distributee to the extent such distributions are attributable to contributions made on behalf of the employee while he was an employee within the meaning of section 401(c)(1). In other words, in the case of an individual who was covered under a qualified plan both while he was an employee within the meaning of common law and while he was a self-employed individual, the capital gains treatment could only apply to that part of a distribution that is attributable to contributions made on his behalf while he was an employee within the meaning of common law.

Section 403(a)

Existing section 403(a) provides the tax treatment for distributions under qualified nontrusteed annuity plans. Subsection (d)(1) of section 4 of the bill amends section 403(a)(2)(A)(i) to provide that a qualified annuity plan must meet the new qualification requirements included by this bill in sections 401 (a) and (d).

Existing section 403(a)(2) provides capital gains treatment for certain total distributions under qualified annuity plans. Subsection (d)(2) of section 4 of the bill amends section 403(a)(2)(A) to provide that the capital gains treatment shall not apply to amounts paid to any payee to the extent such amounts are attributable to contributions made on behalf of an employee while he was an employee within the meaning of section 401(c)(1). This amendment applies similar treatment to distributions under qualified annuity plans as the amendment made by subsection (c) of section 4 of the bill applies to distributions from qualified trusts.

Subsection (d)(3) of section 4 of the bill adds to section 403(a) a new paragraph (3) providing that, for purposes of section 403(a), the term "employee" includes a self-employed individual within the meaning of section 401(c)(1), and the employer of such individual is the person treated as his employer under section 401(c)(4). This amendment merely makes it clear that a self-employed individual can participate in a qualified annuity plan.

SECTION 5. PLANS FOR PURCHASE OF U.S. BONDS

Section 5 of the bill adds a new section 405 to the Internal Revenue Code of 1954 to provide for the establishment of qualified bond purchase plans. In general, participants in such a qualified bond purchase plan will be granted tax treatment similar to that granted to participants in qualified pension and profit-sharing plans.

Section 405(a)

Subsection (a) of the new section 405 provides that a plan of an employer for the purchase for and distribution to his employees or their beneficiaries of U.S. bonds described in section 405(b) shall constitute a qualified bond purchase plan if—

(1) the plan meets the requirements of section 401(a) (3), (4), (5), (6), (7), and (8) and, if applicable, the requirements of section 401(a) (9) and (10) and of section 401(d) (other than subparagraphs (1), (5)(B) and (8)); and

(2) contributions under the plan are used solely to purchase for employees or their beneficiaries the U.S. bonds described in section 405(b).

A qualified bond purchase plan can be established by an employer for his employees without the creation of a trust but, if such a plan is established, only the special bonds can be purchased under the plan. A qualified trusteed plan can also purchase the special bonds together with other assets but, if a trusteed plan is established, the plan must qualify under section 401 as a pension or profit-sharing plan.

In general, a qualified bond purchase plan must meet the same qualification requirements as a qualified annuity plan. However, sections 401(d) (5)(B) and (8) are not applicable to a qualified bond purchase plan and, consequently, there is no limit on the amount of contributions in excess of those which are deductible that may be made under the plan.

Section 405(b)

Subsection (b)(1) of the new section 405 describes the special bond which can be purchased under a qualified bond purchase plan. Such paragraph provides that such a bond is a bond issued under the Second Liberty Bond Act, as amended, which by its terms, or by regulations prescribed by the Secretary under the Second Liberty Bond Act—

(A) provides for payment of interest or investment yield only upon redemption;

(B) may be purchased only in the name of an individual;

(C) ceases to bear interest, or provide investment yield, not later than 5 years after the death of the individual in whose name it is purchased;

(D) may be redeemed before the death of the individual in whose name it is purchased only if such individual—

(i) has attained the age of 59½ years, or

(ii) has become disabled (within the meaning of sec 213(g)(3)); and

(E) is not transferable.

Subsection (b)(2) of the new section 405 provides that bonds purchased under a qualified bond purchase plan must be purchased in the name of the employee for whom it is purchased.

Section 405(c)

Subsection (c) of the new section 405 provides that contributions paid by an employer to or under a qualified bond purchase plan shall be allowed as deductions in an amount determined under section 404 in the same manner and to the same extent as if such contributions were made to a qualified trust described in section 401(a) which is exempt from tax under section 501. Thus, for contributions to a qualified bond purchase plan to be deductible under section 405(c), all of the requirements of section 404 must be met. For example, the contributions must meet the requirements of section 162 or 212, and must be made (or deemed to have been made under section 404(a)(6)) in a taxable year of an employer which ends with or within a year of the bond purchase plan for which it qualifies under section 405.

If the amount of the contributions to the qualified bond purchase plan are determined by reference to the profits of the employer, as in the case of a qualified profit-sharing plan, the amount deductible with respect to such contributions is determined under section 404(a)(3), relating to qualified profit-sharing plans. Moreover, such a bond purchase plan shall be considered a profit-sharing plan for purposes of the provisions in section 404(a)(3) relating to a situation when contributions are made to two or more profit-sharing trusts. In other cases, the amount deductible with respect to contributions to a qualified bond purchase plan will be determined under section 404(a)(1). If the qualified bond purchase plan covers self-employed individuals, the amount deductible with respect to contributions to the plan is subject to the further limitations of section 404(a)(10). Similarly, in the case of a qualified bond purchase plan covering owner-employees, the special rules in section 404(a)(9) for computing the limitations with respect to deductions for contribution under the plan shall be applicable. Thus, the carryover provisions of section 404(a) are not applicable with respect to contributions made under a qualified bond purchase plan on behalf of owner-employees. Moreover, the additional limitations in section 404(e) and 404(a)(10) shall apply in the case of a qualified bond purchase plan covering an owner-employee.

Section 405(d)

Subsection (d)(1) of the new section 405 provides that no amount is includible in the gross income of a distributee at the time a bond described in section 405(b) is distributed to him under a qualified bond purchase plan or from a qualified trust. Upon the redemption of such a bond, however, the proceeds are subject to taxation under chapter 1 of the Internal Revenue Code of 1954. In applying chapter 1, for purposes of determining the amount of tax due, the provisions of sections 72 and 1232 shall not be applied. In other words, the bonds described in section 405(b) received under a qualified bond purchase plan or from a qualified trust are not subject to tax until they are redeemed. In addition, upon redemption, no part of the proceeds will be treated as an amount received from the sale or exchange of a capital asset by reason of section 1232.

Subsection (d)(e) of the new section 405 provides rules for determining the basis of any bond received by a distributee under a qualified bond purchase plan. If the bond was purchased for an employee within the meaning of common law, the basis of such bond shall be

an amount equal to the amount of the contributions made under the plan by the employee himself which were used to purchase the bond. If the bond was purchased for an employee at a time when he was a self-employed individual, the basis of such bond is an amount equal to the amount of the contributions used to purchase the bond which were made on behalf of such employee and which were not allowed as a deduction under section 405(c). Such subsection (d)(2) further provides that the basis of a bond described in section 405(b) which is received by a distributee from a qualified trust shall be determined under regulations prescribed by the Secretary or his delegate.

Section 405(e)

Subsection (e) of the new section 405 provides that the capital gains treatment of section 402(a)(2) shall not apply to any of the bonds described in section 405(b) and that, for purposes of applying section 402(a)(2) to amounts distributed by a qualified trust, any such bonds distributed to any distributee and any such bonds to the credit of any employee shall not be taken into account. In other words, for purposes of applying section 402(a)(2), a distribution under a qualified trust may be considered a total distribution of an employee's interest in such trust even though the trust retains bonds described in section 405(b). In the case of a distribution from a qualified trust which qualifies for the capital gains treatment of section 402(a)(2) and which includes both bonds of the type described in section 405(b) and other property, the capital gains treatment will be applicable to such other property. In no case, however, will the capital gains treatment be applicable to the proceeds received as a result of the redemption of any of the bonds described in section 405.

Section 405(f)

Subsection (f) of the new section 405 provides that, for purposes of section 405, the term "employee" includes an individual who is an employee within the meaning of section 401(c)(1), and the employer of such individual shall be the person treated as his employer under section 401(c)(4). Such subsection (f) has the effect of enabling the self-employed individual to participate in a qualified bond purchase plan to the same extent that he may participate in qualified pension, annuity and profit-sharing plans.

Section 405(g)

Subsection (g) of the new section 405 provides that, at the time of the purchase of any of the bonds described in section 405, proof of such purchase shall be furnished in such form as will enable the purchaser, and the employee in whose name such bond is purchased, to comply with the provisions of section 405.

Section 405(h)

Subsection (h) of the new section 405 provides that the Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the provisions of section 405.

SECTION 6. PROHIBITED TRANSACTIONS

Section 6 of the bill amends section 503 of the Internal Revenue Code of 1954 to provide a special definition of the term "prohibited transaction" in the case of certain qualified employees' trust covering

owner-employees. This special definition is only applicable when the owner-employees covered by the qualified employees' trust, control the trade or business with respect to which the trust is established.

Section 6 of the bill adds to section 503 a new subsection (j) which provides that, in the case of a trust described in section 401(a) which is part of a plan covering owner-employees (as defined in sec. 401(c)(3)) who control the trade or business with respect to which the plan is established, the term "prohibited transaction" means, in addition to the transactions described in section 503(c), any transaction in which such trust, directly or indirectly—

(A) lends any part of the corpus or income of the trust to;

(B) pays any compensation for personal services rendered to the trust to;

(C) makes any part of its services available on a preferential basis to; or

(D) acquires for the trust any property from, or sells any property to;

any person described in section 503(c) or to any such owner-employee, a member of the family (as defined in sec. 267(c)(4)) of any such owner-employee, or a corporation controlled by such owner-employee through the ownership, directly or indirectly, of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of the corporation.

For purposes of determining whether owner-employees covered under a qualified employees' trust control the trade or business with respect to which such trust is established, the rules in section 401(d)(9)(B), determined with the application of the rules of constructive ownership in section 401(c)(5), are to be applied.

Paragraph (2) of the new subsection (j) provides that, for purposes of the new definition of "prohibited transaction" in paragraph (1), the following rules shall apply with respect to a loan made before the date of the enactment of the bill which would be a prohibited transaction if made in a taxable year beginning after December 31, 1961:

(A) If any part of the loan is repayable prior to December 31, 1964, the renewal of such part of the loan for a period not extending beyond December 31, 1964, on the same terms, shall not be considered a prohibited transaction.

(B) If the loan is repayable on demand, the continuation of the loan beyond December 31, 1964, shall be considered a prohibited transaction.

SECTION 7. OTHER SPECIAL RULES, TECHNICAL CHANGES, AND ADMINISTRATIVE PROVISIONS

Section 7 of the bill provides certain technical amendments and administrative provisions.

Section 7(a) of the bill amends section 37 of the Internal Revenue Code of 1954, relating to the retirement income credit, to make clear that any distribution to a self-employed individual under a qualified pension, annuity, or profit-sharing plan, and that any income derived by any person from the bonds described in section 405(b) received under a qualified bond purchase plan or from a qualified trust, may qualify as retirement income for purposes of such credit.

Section 7(b) of the bill amends section 62 of the Internal Revenue Code of 1954, relating to the definition of "adjusted gross income," to provide that, in computing adjusted gross income, there shall be allowed, in the case of a self-employed individual, the deductions allowed under sections 404 and 405 for contributions on behalf of such an individual to a qualified pension, annuity, profit-sharing, or bond-purchase plan.

Section 7(c) of the bill amends section 101(b) of the Internal Revenue Code of 1954, relating to employees' death benefit. Paragraph (1) of section 7(c) amends section 101(b) so that the rule applicable to distributions under a qualified annuity plan will only apply if the annuity plan meets the new qualification requirements of section 401 (a) and (d) applicable to annuity plans.

Paragraph (2) of section 7(c) amends section 101(b) by adding a new paragraph (3), which provides that, for purposes of section 101(b), the term "employee" does not include an individual who is an employee within the meaning of section 401(c)(1) (relating to self-employed individuals). Thus, if at the time of his death, a self-employed individual is a participant in a qualified pension, annuity, or profit-sharing plan and after his death a distribution is made to his beneficiary, the exclusion of section 101(b) is not applicable to any portion of such distribution even though such individual was at one time an employee (under common law) of the trade or business and a portion of the distribution is attributable to contributions which were made while he was such an employee. Similarly, the exclusion of section 101(b) is not applicable to any portion of a distribution from such a qualified plan on behalf of an individual who was retired at the time of his death and who at the time of his retirement participated in the plan as a self-employed individual.

Section 7(d) of the bill amends section 104(a) of the Internal Revenue Code of 1954, relating to compensation for injuries or sickness, to make clear that the exclusion of such section is not applicable to any benefits which are attributable to contributions to a qualified pension, annuity, or profit-sharing plan on behalf of an individual while he was a self-employed individual to the extent that such contributions were allowed as deductions under section 404.

Section 7(e) of the bill amends section 105 of the Internal Revenue Code of 1954, relating to amounts received under accident and health plans, by adding a new subsection (g) which provides that, for purposes of section 105, the term "employee" does not include an individual who is an employee within the meaning of section 401(c)(1) (relating to self-employed individuals). For example, if at the time an individual commences to receive benefits described in section 105 from a qualified pension plan, he is covered under such plan as a self-employed individual, such benefits do not qualify for the exclusion of section 105.

Section 7(f) of the bill amends section 172 (d)(4) of the Internal Revenue Code of 1954, relating to net operating loss deductions, to make clear that any deduction under section 404 or 405 attributable to contributions on behalf of a self-employed individual under a qualified employees' plan shall not be treated as attributable to the trade or business of such individual for purposes of section 172.

Section 7(g) of the bill makes conforming amendments to section 805 of the Internal Revenue Code of 1954, relating to pension plan reserves of life insurance companies.

Section 7(h) of the bill amends section 1361 of the Internal Revenue Code of 1954, relating to unincorporated business enterprises electing to be taxed as domestic corporations, to permit a partner or proprietor of such an unincorporated business to participate in a qualified pension, annuity, profit-sharing, or bond-purchase plan. However, for purposes of applying all the provisions relating to such qualified plans, such a partner or proprietor shall be considered a self-employed individual and will be considered an employee only to the extent he is so considered under section 401(c)(1).

Section 7(i) of the bill amends section 2039 of the Internal Revenue Code of 1954, relating to exemption from gross estate of annuities under certain trusts and plans. Paragraph (1) of section 7(i) amends section 2039(c)(2) to provide that the exclusion of the value of an annuity under a qualified annuity plan will be applicable only if the annuity plan meets the additional qualification requirements of sections 401 (a) and (d). Paragraph (2) of section 7(i) amends section 2039(c) by adding at the end thereof a new sentence which provides that, for purposes of section 2039(c), contributions or payments on behalf of the decedent while he was an employee within the meaning of section 401(c)(1) made under a qualified pension, annuity, or profit-sharing plan shall be considered to be contributions or payments made by the decedent. Accordingly, the estate tax exclusion of section 2039(c) is not applicable to the portion of a decedent's interest in a qualified plan which is attributable to contributions on behalf of an individual while he was a self-employed individual.

Section 7(j) of the bill amends section 2517 of the Internal Revenue Code of 1954, relating to exclusion from gift tax in case of certain annuities under qualified plans, in the same manner as section 7(i) of the bill amends the estate tax exclusion with respect to qualified plans.

Sections 7 (k) and (l) of the bill amend section 3306(b)(5) of the Internal Revenue Code of 1954 (relating to the Federal Unemployment Tax Act) and section 3401(a)(12) of such code (relating to the withholding of income tax). These amendments make conforming changes and exclude from the definition of "wages" under such sections any payment made to, or on behalf of, an employee or his beneficiary, under or to a bond-purchase plan which, at the time of such payment, is a qualified bond-purchase plan described in section 405.

Section 7(m) of the bill amends the Internal Revenue Code of 1954 to add a new section 6047, giving the Secretary or his delegate authority to require the furnishing of additional information which is necessary to administer the new provisions in this bill. Section 7(m) of the bill also amends section 7207 of the 1954 code to provide penalties for willfully furnishing false or fraudulent information.

SECTION 8. EFFECTIVE DATE

Section 8 of the bill provides that the amendments made by this bill will be applicable to taxable years beginning after December 31, 1961.

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MINORITY VIEWS ON H.R. 10

In our opinion, H.R. 10 should not be enacted into law. This measure violates every rule of equity and fair play in that it sets up a program in which only a few of the already fortunately situated can participate. Furthermore, it sets a dangerous precedent by allowing a tax deduction to be taken by a taxpayer for actions which that taxpayer voluntarily takes for his own peculiar benefit.

On very practical grounds there are also serious objections. The bill singles out for assistance a class of people, the self-employed, who as a group are, generally speaking, least in need or deserving of assistance. The doctor, lawyer, or small businessman is not forced to retire at a specified age. He typically builds up a practice or business, takes in younger associates, and continues to benefit from such practice or business well beyond the earning years of the average employee. Then too, the bill badly erodes the tax base at a time when the crying need is for tax reform through broadening that base. If we can afford the revenue loss which this bill represents, we can certainly suffer such loss in order to gain more worthy objectives.

The bill fails even to accomplish its major ostensible objective of equating retirement privileges of the self-employed with those of the executive of closely held corporations. To achieve parity in this regard, limitations of considerable stringency would need to be placed on corporate executives. The committee refused to acknowledge this fact and summarily voted down all attempts in that direction.

The entire pension and profit sharing area is in dire need of a thorough cleanup. The enactment of this legislation does nothing to improve existing law. It merely rather loosely bastes another patch on this crazy quilt.

Some of these points require elaboration.

THE TAX BENEFITS OF THE BILL

This bill would extend to the so-called self-employed individuals certain tax benefits in connection with funds which such individuals set aside for their retirement. A part of the funds so set aside would be deductible from current income for income tax purposes, and the earnings on such funds would be entirely exempt from current taxation. Although the funds and earnings would be taxable when withdrawn, the opportunity to postpone taxation of the funds and earnings represents a very significant tax advantage, especially to those people receiving very large incomes when the funds are set aside. (1) When the funds and earnings are withdrawn, the taxpayer almost invariably will be receiving less income and, consequently, the funds and earnings will be taxable at a lower rate. (2) Furthermore, the interest received on his savings during the period of accumulation, although really a part of his income, will not be taxable although if the savings were invested in stocks, bonds, mortgages, or bank deposits, the interest would be taxable. (3) In addition, the taxpayer may, when he withdraws the funds and earnings, be entitled to the retirement income

credit and the additional exemptions allowed individuals over age age 65, and these benefits would further reduce the tax ultimately paid on the funds set aside for retirement.

ILLUSTRATION OF TAX BENEFITS

The very attractive tax benefits which would result from the enactment of the bill may be illustrated by the following example. If a self-employed individual, whose earned income is $20,000 a year, contributes $2,000 a year to a retirement plan qualifying under the bill, each $2,000 contribution would entitle him to a $1,500 deduction. If this self-employed individual has no other income subject to tax, is married, has two dependents in addition to his wife, and is entitled to itemized deductions equal to 10 percent of his income for each year, each $1,500 deduction would reduce his taxes by $450. Thus, each year's contribution of $2,000 would bring an immediate after-tax return of $450, or 22½ percent of the contribution. If a contribution of this amount is made each year for 30 years, the aggregate tax savings attributable to these deductions would be $13,500. In addition, the total sum accumulated under the retirement plan at the end of 30 years would be $105,000, assuming an interest rate of 3½ percent. This total sum would include $45,000 of accumulated interest, but if the interest were currently taxable to the self-employed individual, there would have been approximately $14,900 less of accumulated interest in the fund. Thus, almost $15,000 of the fund is due to exemption of the interest income from current taxation. This is a tax saving of $15,000 in addition to the $13,500 tax savings attributable to the deductions or a total of $28,500.

INSIGNIFICANCE OF EMPLOYEE REQUIREMENT

A self-employed individual who is an employer and who desires to take advantage of the bill would be required to set up a retirement plan covering his permanent full-time employees with more than 3 years of service. However, this requirement may not have as much significance as would first appear. In the first place, the privilege of excluding employees with less than 3 years of service would permit many of the employers for whom the bill would be enacted to exclude a large number of employees from participation in any retirement plan established by the employer. Moreover, any contributions which an employer makes on behalf of his employees will also be deductible in computing the employer's tax.

AN UNWARRANTED SUBSIDY

In these times, we of the Congress are confronted with many very grave problems. Our Nation is engaged in a frightening contest with communism, and our interests are being threatened throughout the world. Our rights to access to Berlin are being challenged, and to meet this thrust and the other advances of communism and to demonstrate to the Russians that we will not compromise principle, we must increase our Armed Forces. To provide this increase in our military strength, we have recently approved increased appropriations of more than $3 billion.

The Russians are also challenging us by attempting to influence and control the underdeveloped nations of the world. To meet this challenge and to assist the deserving people of the world, we have just authorized the spending of more than $4.2 billion this year and have authorized the President to commit $11.9 billion during the next 5 years.

In addition to meeting these threats by the Russians, we must maintain a healthy and growing society in the United States. We must not sacrifice our own sources of strength, such as the education of our young people. In fact, we must appropriate substantially more money to the improvement of our educational system.

The enactment of this bill would result in an annual loss of revenue which is estimated to be almost $200 million. The enactment of such legislation is in effect the granting of a subsidy of almost $200 million to the people who would be benefited by the legislation. Let us see who is requesting this large subsidy.

SMALL GROUP WOULD BENEFIT

The self-employed individuals who would be granted a tax reduction by this bill include those people who own and operate businesses. The most active proponents of the legislation include organized groups of doctors, lawyers, and accountants. It is said that there are more than 6 million self-employed individuals in this country who might benefit by the legislation. However, in fact, according to the estimates of the Treasury Department, about 80 percent of the tax reductions which would be allowed by the bill would be received by self-employed people with an annual income in excess of $10,000, and about 50 percent of such tax reductions would be received by self-employed people with an annual income in excess of $20,000. Now, there are about 379,000 self-employed people in the United States with an annual income in excess of $20,000. These people constitute only about 6 percent of the self-employed people subject to tax, but this 6 percent would receive about 50 percent of the tax benefits which would be provided by the bill. Thus, although it is argued that the bill would benefit many people, it is apparent that the primary benefit will be derived by a very small group. Furthermore, the group which would derive the primary benefit consists of individuals who are receiving very substantial incomes and who do not need any preferential tax treatment to enable them to provide for their retirement.

The professions which are represented by these groups are among the most honorable, and deservedly well rewarded in our country. In 1955, for example, the average annual income of all doctors was $18,122, and of family physicians was $15,000. The average annual income in 1958 of dentists was $13,956.

In 1954 the average annual income of lawyers was $10,258. The average annual income of senior public accountants in 1958 ranged from $8,000 to $10,000. The present average income of both doctors and lawyers is obviously substantially higher than these figures.

These incomes compare with an average annual income in 1960 of all wage and salary workers of only $4,705, and of wage and salary workers in manufacturing of $5,342.

TAX EVASION AND AVOIDANCE GREATEST FOR SELF-EMPLOYED

In testimony before a subcommittee of the Appropriations Committee of the Senate, Secretary Dillon reported on some estimates made by the Internal Revenue Service concerning unreported taxable income. According to these estimates, $24.4 billion of taxable income was not reported for the year 1959. Of this amount, $12 billion was income received by individuals engaged in business or farming. Thus, the very class of people who are requesting the tax concessions which would be provided by this bill were responsible for almost one-half of the unreported taxable income in 1959. The amount of unreported taxable income received by this group exceeded the amount of such income received by any other group in our society. Moreover, the amount of unreported taxable income received by this group constituted between 25 and 27 percent of the total amount of taxable income received by that group. Percentagewise, their record is worse than any other group of taxpayers. Many people engaged in businesses faithfully perform their obligations to report their income and assume their proper share of the tax burden, and these people should not be condemned for the failures of others in their class. However, in view of this very poor record of tax compliance, it seems to us that this group as a class does not seriously merit consideration for receiving tax concessions.

WHY TAX REDUCTION FOR THE SELF-EMPLOYED

This Congress may in the near future be asked by the President to increase taxes. If the people who are urging us to adopt this bill came before us and requested us to appropriate them a subsidy of almost $200 million, we believe that this Congress would not seriously consider such a request. In view of the demands upon the public Treasury for appropriations of huge sums for national defense and other very worthwhile and necessary public objectives, the request of these people for a subsidy must rank very low in priority. Yet, by asking for the tax concessions which would be provided by this bill, these people are asking for just such a subsidy, and their request for these tax concessions should be considered no more favorably than their request for a similar subsidy.

EROSION OF THE TAX BASE

In his tax message to the Congress, the President recognized and pointed out to the Congress the need for a fundamental revision of our tax system. He announced that he had directed the Secretary of the Treasury to study the tax system with the view of submitting a proposed revision of the tax law. Even before this statement of the President, this need for a fundamental revision of our tax system was considered by the Joint Economic Committee and the House Ways and Means Committee, and many of those who appeared before those committees also recognized the urgent need for a redistribution of the tax burden.

The present law contains many provisions which extend preferred tax treatment to selected groups of taxpayers. The result of the preferred tax treatment received by these groups is that the rates of

tax imposed upon other taxpayers generally are higher than they otherwise would be. In other words, many people feel that the present tax rates are too high; yet, if these rates are to be reduced, the resulting loss of revenue must be offset by removing the preferred tax treatment now received by selected groups of taxpayers. By redistributing the tax burden in this manner, all taxpayers would be treated more equitably. In fact, although any discussion of the tax law becomes technical and therefore is of little interest to most people, it is our observation that more and more people are recognizing the fundamental facts that some groups of taxpayers are receiving more favorable tax treatment and that if these special tax provisions were eliminated, the rates for all taxpayers could be reduced.

This bill is inconsistent with the recognized need for redistributing the tax burden. By extending to the self-employed favorable tax treatment for their retirement savings, the bill would further erode the tax base. What is more, the granting of these tax benefits to the self-employed is likely to lead to further erosion of the tax base. If self-employed people are to receive preferred tax treatment for their retirement savings, equity would seem to require that similar treatment should be provided for other taxpayers. The employers of many employees have not established retirement plans for their employees, and if this bill is adopted, it would seem that these employees should also receive comparable tax treatment for their retirement savings. Furthermore, many employees who are nominally covered by present retirement plans do not, in fact, have any substantial rights under these plans. Thus, it would seem, if this bill is adopted, that these employees who are inadequately covered by present retirement plans should also receive comparable tax treatment for their retirement savings. To extend similar tax treatment to the employees who are not covered by employer-sponsored retirement plans or whose coverage under such plans is inadequate would cause a loss of revenue of about $1.7 billion.

If the self-employed are permitted to deduct the funds which they set aside for their retirement, employees who are required to make contributions to the social security system, to the railroad retirement system, to other Government plans, or to plans established by their employers will claim that they too should be permitted to deduct the contributions for their retirement. To allow employees to deduct their contributions to the social security system would cost about $1.1 billion of revenue. Fifty-five million dollars of revenue would be lost if employees were permitted to deduct their contributions to the railroad retirement system; $370 million would be lost if employees were permitted to deduct their contributions to Federal, State, and local government plans; and $165 million of revenue would be lost if employees were permitted to deduct their contributions to private retirement plans. If this bill is adopted, the Congress will receive requests to allow these additional deductions and if these deductions are allowed, the aggregate loss of revenue would be staggering. That loss of revenue would have to be met either by deficit financing or by increasing the taxes imposed upon taxpayers generally.

Although we are opposed to further erosion of the tax base and to any action which would result in such a large loss of revenue, we offered for the consideration of the committee an amendment which would have extended comparable tax benefits to employees who are

not covered or who are inadequately covered by employer-sponsored retirement plans, but the committee rejected our amendment. Although by rejecting this amendment, the committee has refused to recognize at this time the compelling equity of the case of these employees for receiving comparable tax benefits, the enactment of this bill will inevitably lead to more and more requests by such employees for similar tax concessions.

DEDUCTIONS FOR OTHER FORMS OF SAVINGS

This bill deals with retirement savings, but the question will be asked why should retirement savings be treated more favorably than other personal expenses? If we are to allow tax incentives for retirement savings, why should we not also allow tax deductions for the expenses of sending children to school or the costs of purchasing a family residence? It is socially desirable to encourage people to provide for their own retirement, but it would seem equally desirable to encourage the further education of our children and to encourage the purchase of family residences. We see no adequate basis for extending tax concessions to retirement savings without extending similar tax concessions to many other socially desirable causes. The Congress must come to recognize that if we submit to the importuning of every group which asks for some special tax concession for funds set aside for some laudatory purpose, the base of the income tax will be destroyed, and we will be left with a tax on consumption—not income.

Since the percentages devoted to consumption decrease and the proportions set aside for savings increase as total income increases,[1] this means that a smaller and smaller percentage of total income would be subject to income taxation. State and local taxation, based primarily upon sales taxes and real property, is already quite heavily regressive. A great reduction in the progressive features of the Federal income tax would probably make the total tax structure regressive and one which would weigh more heavily upon those with low and moderate means than upon those with larger annual incomes. There would also be a greater concentration of economic power. These are social consequences which we do not like and regard as detrimental to the ideals of our democratic society. As we preach tax reform to the Latin Americans, let us not violate these principles ourselves. Social justice is for internal use and not merely for export.

It is true that the present law provides tax benefits for retirement plans established by an employer for his employees. However, in view of the pending reconsideration of the proper base for imposing an income tax, we believe that no preferred tax treatment should be extended to any additional selected group of taxpayers. In time, we can consider the basic question of whether retirement savings should be treated differently than other personal expenses, and when that decision is made, we can then adopt laws which treat all people in a comparable and equitable manner.

When this basic question is fully considered, should it be decided to give a tax concession to encourage savings for retirement, there are several groups which must be treated differently. The ordinary employee, the highly compensated corporate executive, the owner-

[1] The technical description for this is that the income elasticity of consumption is less than unity and that for savings is greater than unity. This is borne out by a large number of budgetary studies.

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manager of a closely held corporation, the self-employed professional man, and the owner of a nonincorporated business all require somewhat different treatment in order to arrive at comparable and equitable solution.

TAX REFORM NEGLECTED

In the past 2 years, this committee has spent many days considering the plea of the self-employed for tax relief in connection with their retirement savings. Instead of spending our time on this subject the committee should have devoted this time to a study of the abuses which are prevalent in our present tax system and a study of the means of reforming this system. In his tax message to the Congress, the President submitted a modest program of tax reform for the consideration of the Congress this year. However, this committee has given no serious consideration to those Presidential recommendations.

To provide the committee with an opportunity to consider these recommendations, we offered amendments to H.R. 10 which would have closed the door on some of the most conspicuous means of tax avoidance or evasion. These amendments included a proposal to withhold upon dividends and interest at the source, to correct the widespread practice of claiming excessive tax deductions for entertainment and travel expenses, to reduce the extraordinary and unjustified depletion allowances, to remove the wholly undesirable dividends received credit, and to prevent corporate executives from converting their compensation into capital gains by receiving stock options. All these amendments were rejected by the committee. It is because of the abuses which would have been corrected by these amendments and because of other tax concessions to favored groups that our people generally are required to pay the present high rates of tax, and this committee cannot much longer continue to refuse to face this deplorable situation.

The continued refusal of the Senate Finance Committee to deal with well known and greatly abused methods and systems of tax avoidance, while at the same time repeatedly recommending tax reductions, favors, and concessions to special groups, cannot help but bring our entire tax system into disrepute and disrespect. We insist that the public interest would be served by removal and repeal of tax loopholes. Conversely, we insist that creating one more favoritism after another adversely affects the public interest.

THE FAILURES OF THE BILL

The proponents of the bill argue on its behalf that the self-employed people are the victims of discrimination. If an employer establishes a retirement plan for his employees which meets certain requirements of the present law, the employees are not currently taxable on the funds which are set aside for their retirement, and the earnings on such funds are also exempt from current taxation. If a business is incorporated, and the owners work in the business, they can participate in such a retirement plan and derive these tax advantages. It is argued that since some businesses cannot be incorporated, the owners of such businesses should receive comparable tax treatment. In many States, statutes have recently have been enacted which permit professional people to incorporate or to form professional associa-

tions which would be treated like corporations for Federal tax purposes. It is argued that this bill should be adopted to provide the self-employed who are not incorporated with comparable tax treatment and to eliminate the pressures for the adoption of the State statutes permitting the formation of professional corporations or associations. However, this bill would not accomplish these objectives.

If this bill is adopted, there would still remain very substantial differences in the tax treatment of incorporated and unincorporated businesses. The bill would place limits on the deductions which would be allowable with respect to contributions on behalf of the owners of unincorporated businesses, but no comparable limits would be placed on deductions for contributions on behalf of owners who are technically employees of incorporated businesses. Owners of incorporated businesses would continue to receive the privilege of having certain total distributions from plans covering them treated as long-term capital gains, although this privilege would not be extended to the owners of unincorporated businesses.

For example, the committee has been informed by the Treasury that there are instances in which lump-sum distributions in excess of $800,000 have been made to a corporation executive from sums set aside for his benefit. Under existing law, distribution of these large sums is accorded the 25-percent capital gains tax rate. In reality, such "income" bears no relationship whatever to capital gains in the ordinary meaning of that term. Rather, such a distribution reflects an accumulation of ordinary income, the distribution of which has been deferred.

Similarly, the interest of an owner under a corporate plan would continue to be exempt from the gift tax and the estate tax, but the interest of an owner under an unincorporated plan would not receive these tax advantages. The bill would place other restrictions on the qualifying plans of the self-employed, but comparable restrictions would not be placed upon corporate plans.

BILL MORE UNDESIRABLE THAN 1960 VERSION

When this committee considered this matter last year, it recognized the need to treat substantial owners in a similar manner, regardless of whether the business was incorporated or unincorporated. Although there were some unfortunate differences between the treatment of corporate owners and the self-employed, the bill which this committee acted upon favorably last year was materially better than this bill because it did contain some limits on the abuses which occur under the present corporate plans. We thought it inadvisable to act favorably upon last year's bill, but we consider this bill infinitely more undesirable.

Any legislation dealing with retirement savings must recognize the need to treat all people in a comparable manner. Theoretically, all people could be treated alike by permitting them to participate in retirement plans subject only to the rules of the present law, but this possibility seems to be unacceptable. The alternative is to place similar restrictions upon all participants in retirement plans which receive preferred tax treatment. As a minimum, any legislation relating to retirement savings must include restrictions upon the benefits

with respect to which the favored tax treatment is to be extended. Such legislation should, like last year's bill, place limits on the participation of corporate owners, but unlike last year's bill, those limits should not be more favorable than the limits which are imposed upon self-employed people. Last year's bill was also defective in that it failed to include limits on the participation of corporate executives. Accordingly, that bill in effect discriminated against closely held corporations and in favor of the larger widely held corporations. This discrimination is unfortunate and unjustifiable, and to avoid it, comparable limits should be placed upon the participation of corporate executives.

IMPROVING AMENDMENTS DEFEATED

Despite our view that we should not consider at this time the extension of preferred tax treatment to any other group, we thought that if the Congress is going to consider this bill at this time, we should make every effort to improve the bill. To this end, we offered amendments which would have made the bill more equitable by placing similar restrictions upon corporate plans, but the committee rejected all of these attempts to reform the abuses which are now occurring under corporate plans.

Since corporate plans would continue to receive more favorable tax treatment, we may be assured that if this bill is enacted, its advocates will come before this committee in future years to complain about the discrimination against the self-employed and to argue that the self-employed should be allowed to participate in retirement plans to the same extent as corporate owners. Thus, even if the Congress granted the present requests of the advocates of the self-employed, it will not be long until they are here again asking for liberalization of the rules established by this bill. Furthermore, as long as the law allows them substantially greater tax advantages under corporate plans, we may be certain that the professional people will take advantage of the opportunities to incorporate which some States have provided for then and that they will continue to seek new State statutes permitting them to form professional corporations or associations. After all, they can point to the vastly different tax treatment which applies to corporate plans and argue that to eliminate this discrimination, they should be permitted to incorporate. Thus, the enactment of the bill would not satisfy the self-employed but would merely permit them to take the first step in securing further tax concessions for their retirement savings.

Paul H. Douglas.
Albert Gore.

[H.R. 10] [1]

SELF-EMPLOYED INDIVIDUALS TAX RETIREMENT ACT OF 1962

[Conference Report No. 2411, Eighty-seventh Congress, Second Session]

[September 18, 1962]

Mr. Mills, from the committee of conference, submitted the following Conference Report to accompany H.R. 10.

The committee of conference on the disagreeing votes of the two Houses on the amendment of the Senate to the bill (H.R. 10) to encourage the establishment of voluntary pension plans by self-employed individuals, having met, after full and free conference, have agreed to recommend and do recommend to their respective Houses as follows:

That the House recede from its disagreement to the amendment of the Senate and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following:

That this Act may be cited as the "Self-Employed Individuals Tax Retirement Act of 1962".

SEC. 2. QUALIFICATION OF PLANS.

Section 401 of the Internal Revenue Code of 1954 (relating to qualified pension, profit-sharing, and stock bonus plans) is amended—

(1) by adding at the end of paragraph (5) of subsection (a) the following new sentence: "For purposes of this paragraph and paragraph (10), the total compensation of an individual who is an employee within the meaning of subsection (c)(1) means such individual's earned income (as defined in subsection (c)(2)), and the basic or regular rate of compensation of such an individual shall be determined, under regulations prescribed by the Secretary or his delegate, with respect to that portion of his earned income which bears the same ratio to his earned income as the basic or regular compensation of the employees under the plan bears to the total compensation of such employees.";

(2) by adding at the end of subsection (a) the following new paragraphs:

[1] Public Law 87–792, page 89, this Bulletin.

"(7) A trust shall not constitute a qualified trust under this section unless the plan of which such trust is a part provides that, upon its termination or upon complete discontinuance of contributions under the plan, the rights of all employees to benefits accrued to the date of such termination or discontinuance, to the extent then funded, or the amounts credited to the employees' accounts, are nonforfeitable. This paragraph shall not apply to benefits or contributions which, under provisions of the plan adopted pursuant to regulations prescribed by the Secretary or his delegate to preclude the discrimination prohibited by paragraph (4), may not be used for designated employees in the event of early termination of the plan.

"(8) A trust forming part of a pension plan shall not constitute a qualified trust under this section unless the plan provides that forfeitures must not be applied to increase the benefits any employee would otherwise receive under the plan.

"(9) In the case of a plan which provides contributions or benefits for employees some or all of whom are employees within the meaning of subsection (c)(1), a trust forming part of such plan shall not constitute a qualified trust under this section unless, under the plan, the entire interest of each employee—

"(A) either will be distributed to him not later than his taxable year in which he attains the age of 70½ years, or, in the case of an employee other than an owner-employee (as defined in subsection (c)(3)), in which he retires, whichever is the later, or

"(B) will be distributed, commencing not later than such taxable year, (i) in accordance with regulations prescribed by the Secretary or his delegate, over the life of such employee or over the lives of such employee and his spouse, or (ii) in accordance with such regulations, over a period not extending beyond the life expectancy of such employee or the life expectancy of such employee and his spouse.

A trust shall not be disqualified under this paragraph by reason of distributions under a designation, prior to the date of the enactment of this paragraph, by any employee under the plan of which such trust is a part, of a method of distribution which does not meet the terms of the preceding sentence.

"(10) In the case of a plan which provides contributions or benefits for employees some or all of whom are owner-employees (as defined in subsection (c)(3))—

"(A) paragraph (3) and the first and second sentences of paragraph (5) shall not apply, but—

"(i) such plan shall not be considered discriminatory within the meaning of paragraph (4) merely because the contributions or benefits of or on behalf of employees under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of such employees, and

"(ii) such plan shall not be considered discriminatory within the meaning of paragraph (4) solely because under the plan contributions described in subsection (e)(3)(A) which are in excess of the amounts which may be deducted under section 404 (determined without regard to section 404(a)(10)) for the taxable year may be made on behalf of any owner-employee; and

"(B) a trust forming a part of such plan shall constitute a qualified trust under this section only if the requirements in subsection (d) are also met."; and

(3) by redesignating subsection (c) as subsection (h) and inserting after subsection (b) the following new subsections:

"(c) Definitions and Rules Relating to Self-Employed Individuals and Owner-Employees.—For purposes of this section—

"(1) Employee.—The term 'employee' includes, for any taxable year, an individual who has earned income (as defined in paragraph (2)) for the taxable year. To the extent provided in regulations prescribed by the Secretary or his delegate, such term also includes, for any taxable year—

"(A) an individual who would be an employee within the meaning of the preceding sentence but for the fact that the trade or business carried on by such individual did not have net profits for the taxable year, and

"(B) an individual who has been an employee within the meaning of the preceding sentence for any prior taxable year.

"(2) Earned income.—

"(A) In general.—The term 'earned income' means the net earnings from self-employment (as defined in section 1402(a)) to the extent that such net earnings constitute earned income (as defined in section 911(b) but determined with the application of subparagraph (B)), but such net earnings shall be determined—

"(i) without regard to paragraphs (4) and (5) of section 1402(c),

"(ii) in the case of any individual who is treated as an employee under sections 3121(d)(3) (A), (C), or (D), without regard to paragraph (2) of section 1402(c), and

"(iii) without regard to items which are not included in gross income for purposes of this chapter, and the deductions properly allocable to or chargeable against such items.

For purposes of this subparagraph, sections 911(b) and 1402, as in effect for a taxable year ending on December 31, 1962, and subparagraph (B), as in effect for a taxable year beginning on January 1, 1963, shall be treated as having been in effect for all taxable years ending before such date.

"(B) Earned income when both personal services and capital are material income-producing factors.—In applying section 911(b) for purposes of subparagraph (A), in the case of an individual who is an employee within the meaning of paragraph (1) and who is engaged in a trade or business in which both personal services and capital are material income-producing factors and with respect to which the individual actually renders personal services on a full-time, or substantially full-time, basis, so much of his share of the net profits of such trade or business as does not exceed $2,500 shall be considered as earned income. In the case of any such individual who is engaged in more than one trade or business with respect to which he actually renders substantial personal services, if with respect to all such trades or businesses he actually renders personal services on a full-time, or substantially full-time, basis, there shall be considered as earned income with respect to the trades or businesses in which both personal services and capital are material income-producing factors—

"(i) so much of his share of the net profits of such trades or businesses as does not exceed $2,500, reduced by

"(ii) his share of the net profits of any trade or business in which only personal services is a material income-producing factor.

The preceding sentences shall not be construed to reduce the share of net profits of any trade or business which under the second sentence of section 911(b) would be considered as earned income of any such individual.

"(3) Owner-employee.—The term 'owner-employee' means an employee who—

"(A) owns the entire interest in an unincorporated trade or business, or

"(B) in the case of a partnership, is a partner who owns more than 10 percent of either the capital interest or the profits interest in such partnership.

To the extent provided in regulations prescribed by the Secretary or his delegate, such term also means an individual who has been an owner-employee within the meaning of the preceding sentence.

"(4) Employer.—An individual who owns the entire interest in an unincorporated trade or business shall be treated as his own employer. A partnership shall be treated as the employer of each partner who is an employee within the meaning of paragraph (1).

"(5) Contributions on behalf of owner-employees.—The term 'contribution on behalf of an owner-employee' includes, except as the context otherwise requires, a contribution under a plan—

"(A) by the employer for an owner-employee, and

"(B) by an owner-employee as an employee.

"(d) Additional Requirements for Qualification of Trusts and Plans Benefiting Owner-Employees.—A trust forming part of a pension or profit-sharing plan which provides contributions or benefits for employees some or all of whom are owner-employees shall constitute a qualified trust under this section only if, in addition to meeting the requirements of subsection (a), the following requirements of this subsection are met by the trust and by the plan of which such trust is a part:

"(1) In the case of a trust which is created on or after the date of the enactment of this subsection, or which was created before such date but is not exempt from tax under section 501(a) as an organization described in subsection (a) on the day before such date, the trustee is a bank, but a person (including the employer) other than a bank may be granted, under the trust instrument, the power to control the investment of the trust funds either by directing investments (including reinvestments, disposals, and exchanges) or by disapproving proposed investments (including reinvestments, disposals, and exchanges). This paragraph shall not apply to a trust created or organized outside the United States before the date of the enactment of this subsection if, under section 402(c), it is treated as exempt from tax under section 501(a) on the day before such date; or, to the extent provided under regulations prescribed by the Secretary or his delegate, to a trust which uses annuity, endowment, or life insurance contracts of a life insurance company exclusively to fund the benefits prescribed by the trust, if the life insurance company supplies annually such information about trust transactions affecting owner-employees as the Secretary or his delegate shall by forms or regula-

tions prescribe. For purposes of this paragraph, the term 'bank' means a bank as defined in section 581, a corporation which under the laws of the State of its incorporation is subject to supervision and examination by the commissioner of banking or other officer of such State in charge of the administration of the banking laws of such State, and, in the case of a trust created or organized outside the United States, a bank or trust company, wherever incorporated, exercising fiduciary powers and subject to supervision and examination by governmental authority.

"(2) Under the plan—

"(A) the employees' rights to or derived from the contributions under the plan are nonforfeitable at the time the contributions are paid to or under the plan; and

"(B) in the case of a profit-sharing plan, there is a definite formula for determining the contributions to be made by the employer on behalf of employees (other than owner-employees).

Subparagraph (A) shall not apply to contributions which, under provisions of the plan adopted pursuant to regulations prescribed by the Secretary or his delegate to preclude the discrimination prohibited by subsection (a)(4), may not be used to provide benefits for designated employees in the event of early termination of the plan.

"(3) The plan benefits each employee having a period of employment of 3 years or more. For purposes of the preceding sentence, the term 'employee' does not include any employee whose customary employment is for not more than 20 hours in any one week or is for not more than 5 months in any calendar year.

"(4) Under the plan—

"(A) contributions or benefits are not provided for any owner-employee unless such owner-employee has consented to being included under the plan; and

"(B) no benefits may be paid to any owner-employee, except in the case of his becoming disabled (within the meaning of section 213(g)(3)), prior to his attaining the age of 59½ years.

"(5) The plan does not permit—

"(A) contributions to be made by the employer on behalf of any owner-employee in excess of the amounts which may be deducted under section 404 (determined without regard to section 404(a)(10)) for the taxable year;

"(B) in the case of a plan which provides contributions or benefits only for owner-employees, contributions to be made on behalf of any owner-employee in excess of the amounts which may be deducted under section 404 (determined without regard to section 404(a)(10)) for the taxable year; and

"(C) if a distribution under the plan is made to any employee and if any portion of such distribution is an amount described in section 72(m)(5)(A)(i), contributions to be made on behalf of such employee for the 5 taxable years succeeding the taxable year in which such distribution is made.

Subparagraphs (A) and (B) shall not apply to any contribution which is not considered to be an excess contribution (as defined in subsection (e)(1)) by reason of the application of subsection (e)(3).

"(6) Except as provided in this paragraph, the plan meets the requirements of subsection (a)(4) without taking into account for

any purpose contributions or benefits under chapter 2 (relating to tax on self-employment income), chapter 21 (relating to Federal Insurance Contributions Act), title II of the Social Security Act, as amended, or any other Federal or State law. If—

"(A) of the contributions deductible under section 404 (determined without regard to section 404(a)(10)), not more than one-third is deductible by reason of contributions by the employer on behalf of owner-employees, and

"(B) taxes paid by the owner-employees under chapter 2 (relating to tax on self-employment income), and the taxes which would be payable under such chapter 2 by the owner-employees but for paragraphs (4) and (5) of section 1402(c), are taken into account as contributions by the employer on behalf of such owner-employees,

then taxes paid under section 3111 (relating to tax on employers) with respect to an employee may, for purposes of subsection (a)(4), be taken into account as contributions by the employer for such employee under the plan.

"(7) Under the plan, if an owner-employee dies before his entire interest has been distributed to him, or if distribution has been commenced in accordance with subsection (a)(9)(B) to his surviving spouse and such surviving spouse dies before his entire interest has been distributed to such surviving spouse, his entire interest (or the remaining part of such interest if distribution thereof has commenced) will, within 5 years after his death (or the death of his surviving spouse), be distributed, or applied to the purchase of an immediate annuity for his beneficiary or beneficiaries (or the beneficiary or beneficiaries of his surviving spouse) which will be payable for the life of such beneficiary or beneficiaries (or for a term certain not extending beyond the life expectancy of such beneficiary or beneficiaires) and which will be immediately distributed to such beneficiary or beneficiaries. The preceding sentence shall not apply if distribution of the interest of an owner-employee has commenced and such distribution is for a term certain over a period permitted under subsection (a)(9)(B)(ii).

"(8) Under the plan—

"(A) any contribution which is an excess contribution, together with the income attributable to such excess contribution, is (unless subsection (e)(2)(E) applies) to be repaid to the owner-employee on whose behalf such excess contribution is made;

"(B) if for any taxable year the plan does not, by reason of subsection (e)(2)(A), meet (for purposes of section 404) the requirements of this subsection with respect to an owner-employee, the income for the taxable year attributable to the interest of such owner-employee under the plan is to be paid to such owner-employee; and

"(C) the entire interest of an owner-employee is to be repaid to him when required by the provisions of subsection (e)(2)(E).

"(9)(A) If the plan provides contributions or benefits for an owner-employee who controls, or for two or more owner-employees who together control, the trade or business with respect to which the plan is established, and who also control as an owner-employee or as owner-employees one or more other trades or businesses, such plan

and the plans established with respect to such other trades or businesses, when coalesced, constitute a single plan which meets the requirements of subsection (a) (including paragraph (10) thereof) and of this subsection with respect to the employees of all such trades or businesses (including the trade or business with respect to which the plan intended to qualify under this section is established).

"(B) For purposes of subparagraph (A), an owner-employee, or two or more owner-employees, shall be considered to control a trade or business if such owner-employee, or such two or more owner-employees together—

"(i) own the entire interest in an unincorporated trade or business, or

"(ii) in the case of a partnership, own more than 50 percent of either the capital interest or the profits interest in such partnership.

For purposes of the preceding sentence, an owner-employee, or two or more owner-employees, shall be treated as owning any interest in a partnership which is owned, directly or indirectly, by a partnership which such owner-employee, or such two or more owner-employees, are considered to control within the meaning of the preceding sentence.

"(10) The plan does not provide contributions or benefits for any owner-employee who controls (within the meaning of paragraph (9)(B)), or for two or more owner-employees who together control, as an owner-employee or as owner-employees, any other trade or business, unless the employees of each trade or business which such owner-employee or such owner-employees control are included under a plan which meets the requirements of subsection (a) (including paragraph (10) thereof) and of this subsection, and provides contributions and benefits for employees which are not less favorable than contributions and benefits provided for owner-employees under the plan.

"(11) Under the plan, contributions on behalf of any owner-employee may be made only with respect to the earned income of such owner-employee which is derived from the trade or business with respect to which such plan is established.

"(e) Excess Contributions on Behalf of Owner-Employees.—

"(1) Excess contribution defined.—For purposes of this section, the term 'excess contribution' means, except as provided in paragraph (3)—

"(A) if, in the taxable year, contributions are made under the plan only on behalf of owner-employees, the amount of any contribution made on behalf of any owner-employee which (without regard to this subsection) is not deductible under section 404 (determined without regard to section 404(a)(10)) for the taxable year; or

"(B) if, in the taxable year, contributions are made under the plan on behalf of employees other than owner-employees—

"(i) the amount of any contribution made by the employer on behalf of any owner-employee which (without regard to this subsection) is not deductible under section 404 (determined without regard to section 404(a)(10)) for the taxable year;

"(ii) the amount of any contribution made by any owner-employee (as an employee) at a rate which exceeds the rate of contributions permitted to be made by employees other than owner-employees;

"(iii) the amount of any contribution made by any owner-employee (as an employee) which exceeds the lesser of $2,500 or 10 percent of the earned income for such taxable year derived by such owner-employee from the trade or business with respect to which the plan is established; and

"(iv) in the case of any individual on whose behalf contributions are made under more than one plan as an owner-employee, the amount of any contribution made by such owner-employee (as an employee) under all such plans which exceeds $2,500; and

"(C) the amount of any contribution made on behalf of an owner-employee in any taxable year for which, under paragraph (2)(A) or (E), the plan does not (for purposes of section 404) meet the requirements of subsection (d) with respect to such owner-employee.

For purposes of this subsection, the amount of any contribution which is allocable (determined in accordance with regulations prescribed by the Secretary or his delegate) to the purchase of life, accident, health, or other insurance shall not be taken into account.

"(2) Effect of excess contribution.—

"(A) In general.—If an excess contribution (other than an excess contribution to which subparagraph (E) applies) is made on behalf of an owner-employee in any taxable year, the plan with respect to which such excess contribution is made shall, except as provided in subparagraphs (C) and (D), be considered, for purposes of section 404, as not meeting the requirements of subsection (d) with respect to such owner-employee for the taxable year and for all succeeding taxable years.

"(B) Inclusion of amounts in gross income of owner-employees.—For any taxable year for which any plan does not meet the requirements of subsection (d) with respect to an owner-employee by reason of subparagraph (A), the gross income of such owner-employee shall, for purposes of this chapter, include the amount of net income for such taxable year attributable to the interest of such owner-employee under such plan.

"(C) Repayment within prescribed period.—Subparagraph (A) shall not apply to an excess contribution with respect to any taxable year, if, on or before the close of the 6-month period beginning on the day on which the Secretary or his delegate sends notice (by certified or registered mail) to the person to whom such excess contribution was paid of the amount of such excess contribution, the amount of such excess contribution, and the net income attributable thereto, is repaid to the owner-employee on whose behalf such excess contribution was made. If the excess contribution is an excess contribution as defined in paragraph (1)(A) or (B)(i), or is an excess contribution as defined in paragraph (1)(C) with respect to which a deduction has been claimed under section 404, the notice required by the preceding sentence shall not be mailed prior to

the time that the amount of the tax under this chapter of such owner-employee for the taxable year in which such excess contribution was made has been finally determined.

"(D) Repayment after prescribed period.—If an excess contribution, together with the net income attributable thereto, is not repaid within the 6-month period referred to in subparagraph (C), subparagraph (A) shall not apply to an excess contribution with respect to any taxable year beginning with the taxable year in which the person to whom such excess contribution was paid repays the amount of such excess contribution to the owner-employee on whose behalf such excess contribution was made, and pays to such owner-employee the amount of net income attributable to the interest of such owner-employee which, under subparagraph (B), has been included in the gross income of such owner-employee for any prior taxable year.

"(E) Special rule if excess contribution was willfully made.—If an excess contribution made on behalf of an owner-employee is determined to have been willfully made, then—

"(i) subparagraphs (A), (B), (C), and (D) shall not apply with respect to such excess contribution;

"(ii) there shall be distributed to the owner-employee on whose behalf such excess contribution was willfully made his entire interest in all plans with respect to which he is an owner-employee; and

"(iii) no plan shall, for purposes of section 404, be considered as meeting the requirements of subsection (d) with respect to such owner-employee for the taxable year in which it is determined that such excess contribution was willfully made and for the 5 taxable years following such taxable year.

"(F) Statute of limitations.—In any case in which subparagraph (A) applies, the period for assessing any deficiency arising by reason of—

"(i) the disallowance of any deduction under section 404 on account of a plan not meeting the requirements of subsection (d) with respect to the owner-employee on whose behalf an excess contribution was made, or

"(ii) the inclusion, under subparagraph (B), in gross income of such owner-employee of income attributable to the interest of such owner-employee under a plan,

for the taxable year in which such excess contribution was made or for any succeeding taxable year shall not expire prior to one year after the close of the 6-month period referred to in subparagraph (C).

"(3) Contributions for premiums on annuity, etc., contracts.—A contribution by the employer on behalf of an owner-employee shall not be considered to be an excess contribution within the meaning of paragraph (1), if—

"(A) under the plan such contribution is required to be applied (directly or through a trustee) to pay premiums or other consideration for one or more annuity, endowment, or life insurance contracts on the life of such owner-employee issued under the plan,

"(B) the amount of such contribution exceeds the amount deductible under section 404 (determined without regard to section 404(a)(10)) with respect to contributions made by the employer on behalf of such owner-employee under the plan, and

"(C) the amount of such contribution does not exceed the average of the amounts which were deductible under section 404 (determined without regard to section 404(a)(10)) with respect to contributions made by the employer on behalf of such owner-employee under the plan (or which would have been deductible under such section if such section had been in effect) for the first 3 taxable years (i) preceding the year in which the last such annuity, endowment, or life insurance contract was issued under the plan and (ii) in which such owner-employee derived earned income from the trade or business with respect to which the plan is established, or for so many of such taxable years as such owner-employee was engaged in such trade or business and derived earned income therefrom.

In the case of any individual on whose behalf contributions described in subparagraph (A) are made under more than one plan as an owner-employee during any taxable year, the preceding sentence shall not apply if the amount of such contributions under all such plans for such taxable year exceeds $2,500. Any contribution which is not considered to be an excess contribution by reason of the application of this paragraph shall, for purposes of subparagraphs (B) (ii), (iii), and (iv) of paragraph (1), be taken into account as a contribution made by such owner-employee as an employee to the extent that the amount of such contribution is not deductible under section 404 (determined without regard to section 404(a)(10)) for the taxable year, but only for the purpose of applying such subparagraphs to other contributions made by such owner-employee as an employee.

"(f) Certain Custodial Accounts.—

"(1) Treatment as qualified trust.—For purposes of this title, a custodial account shall be treated as a qualified trust under this section, if—

"(A) such custodial account would, except for the fact that it is not a trust, constitute a qualified trust under this section;

"(B) the custodian is a bank (as defined in subsection (d)(1));

"(C) the investment of the funds in such account (including all earnings) is to be made—

"(i) solely in regulated investment company stock with respect to which an employee is the beneficial owner, or

"(ii) solely in annuity, endowment, or life insurance contracts issued by an insurance company;

"(D) the shareholder of record of any such stock described in subparagraph (C)(i) is the custodian or its nominee; and

"(E) the contracts described in subparagraph (C)(ii) are held by the custodian until distributed under the plan.

For purposes of this title, in the case of a custodial account treated as a qualified trust under this section by reason of the preceding sentence, the custodian of such account shall be treated as the trustee thereof.

"(2) Definition.—For purposes of paragraph (1), the term 'regulated investment company' means a domestic corporation which—

"(A) is a regulated investment company within the meaning of section 851(a), and

"(B) issues only redeemable stock.

"(g) ANNUITY DEFINED.—For purposes of this section and sections 402, 403, and 404, the term 'annuity' includes a face-amount certificate, as defined in section 2(a)(15) of the Investment Company Act of 1940 (15 U.S.C., sec. 80a–2); but does not include any contract or certificate issued after December 31, 1962, which is transferable, if any person other than the trustee of a trust described in section 401(a) which is exempt from tax under section 501(a) is the owner of such contract or certificate."

SEC. 3. DEDUCTIBILITY OF CONTRIBUTIONS TO PLANS.

(a) INCLUSION OF SELF-EMPLOYED INDIVIDUALS.—Section 404(a) of the Internal Revenue Code of 1954 (relating to the deductibility of contributions to pension, annuity, profit-sharing, or stock bonus plans or plans of deferred compensation) is amended—

(1) by striking out in paragraph (2) "and (6)," and inserting in lieu thereof "(6), (7), and (8), and, if applicable, the requirements of section 401(a) (9) and (10) and of section 401(d) (other than paragraph (1)),"; and

(2) by adding after paragraph (7) the following new paragraphs:

"(8) SELF-EMPLOYED INDIVIDUALS.—In the case of a plan included in paragraph (1), (2), or (3) which provides contributions or benefits for employees some or all of whom are employees within the meaning of section 401(c)(1), for purposes of this section—

"(A) the term 'employee' includes an individual who is an employee within the meaning of section 401(c)(1), and the employer of such individual is the person treated as his employer under section 401(c)(4);

"(B) the term 'earned income' has the meaning assigned to it by section 401(c)(2);

"(C) the contributions to such plan on behalf of an individual who is an employee within the meaning of section 401(c)(1) shall be considered to satisfy the conditions of section 162 or 212 to the extent that such contributions do not exceed the earned income of such individual derived from the trade or business with respect to which such plan is established, and to the extent that such contributions are not allocable (determined in accordance with regulations prescribed by the Secretary or his delegate) to the purchase of life, accident, health, or other insurance; and

"(D) any reference to compensation shall, in the case of an individual who is an employee within the meaning of section 401(c)(1), be considered to be a reference to the earned income of such individual derived from the trade or business with respect to which the plan is established.

"(9) PLANS BENEFITING SELF-EMPLOYED INDIVIDUALS.—In the case of a plan included in paragraph (1), (2), or (3) which provides contributions or benefits for employees some or all of whom are employees within the meaning of section 401(c)(1)—

"(A) the limitations provided by paragraphs (1), (2), (3), and (7) on the amounts deductible for any taxable year shall be computed, with respect to contributions on behalf of employees (other than employees within the meaning of section 401(c)(1)), as if such employees were the only employees for whom contributions and benefits are provided under the plan;

"(B) *the limitations provided by paragraphs (1), (2), (3), and (7) on the amounts deductible for any taxable year shall be computed, with respect to contributions on behalf of employees within the meaning of section 401(c)(1)—*

"(i) *as if such employees were the only employees for whom contributions and benefits are provided under the plan, and*

"(ii) *without regard to paragraph (1)(D), the second and third sentences of paragraph (3), and the second sentence of paragraph (7); and*

"(C) *the amounts deductible under paragraphs (1), (2), (3), and (7), with respect to contributions on behalf of any employee within the meaning of section 401(c)(1), shall not exceed the applicable limitation provided in subsection (e).*

"(10) *Special limitation on amount allowed as deduction for self-employed individuals.—Notwithstanding any other provision of this section, the amount allowable as a deduction under paragraphs (1), (2), (3), and (7) in any taxable year with respect to contributions made on behalf of an individual who is an employee within the meaning of section 401(c)(1) shall be an amount equal to one-half of the contributions made on behalf of such individual in such taxable year which are deductible under such paragraphs (determined with the application of paragraph (9) and of subsection (e) but without regard to this paragraph). For purposes of section 401, the amount which may be deducted, or the amount deductible, under this section with respect to contributions made on behalf of such individual shall be determined without regard to the preceding sentence.*"

(b) *Limitations on Deductible Contributions on Behalf of Self-Employed Individuals.—Section 404 of the Internal Revenue Code of 1954 (relating to the deductibility of contributions to pension, annuity, profit-sharing, or stock bonus plans or plans of deferred compensation) is amended by adding after subsection (d) the following new subsections:*

"(e) *Special Limitations for Self-Employed Individuals.—*

"(1) *In general.—In the case of a plan included in subsection (a) (1), (2), or (3), which provides contributions or benefits for employees some or all of whom are employees within the meaning of section 401(c)(1), the amounts deductible under subsection (a) (determined without regard to paragraph (10) thereof) in any taxable year with respect to contributions on behalf of any employee within the meaning of section 401(c)(1) shall, subject to the provisions of paragraph (2), not exceed $2,500, or 10 percent of the earned income derived by such employee from the trade or business with respect to which the plan is established, whichever is the lesser.*

"(2) *Contributions made under more than one plan.—*

"(A) *Overall limitation.—In any taxable year in which amounts are deductible with respect to contributions under two or more plans on behalf of an individual who is an employee within the meaning of section 401(c)(1) with respect to such plans, the aggregate amount deductible for such taxable year under all such plans with respect to contributions on behalf of such employee (determined without regard to subsection (a)(10)) shall not exceed $2,500, or 10 percent of the earned*

income derived by such employee from the trades or businesses with respect to which the plans are established, whichever is the lesser.

"(B) ALLOCATION OF AMOUNTS DEDUCTIBLE.—In any case in which the amounts deductible under subsection (a) (with the application of the limitations of this subsection) with respect to contributions made on behalf of an employee within the meaning of section 401(c)(1) under two or more plans are, by reason of subparagraph (A), less than the amounts deductible under such subsection determined without regard to such subparagraph, the amount deductible under subsection (a) (determined without regard to paragraph (10) thereof) with respect to such contributions under each such plan shall be determined in accordance with regulations prescribed by the Secretary or his delegate.

"(3) CONTRIBUTIONS ALLOCABLE TO INSURANCE PROTECTION.—For purposes of this subsection, contributions which are allocable (determined under regulations prescribed by the Secretary or his delegate) to the purchase of life, accident, health, or other insurance shall not be taken into account.

"(f) CERTAIN LOAN REPAYMENTS CONSIDERED AS CONTRIBUTIONS.—For purposes of this section, any amount paid, directly or indirectly, by an owner-employee (within the meaning of section 401(c)(3)) in repayment of any loan which under section 72(m)(4)(B) was treated as an amount received under a contract purchased by a trust described in section 401(a) which is exempt from tax under section 501(a) or purchased as a part of a plan described in section 403(a) shall be treated as a contribution to which this section applies on behalf of svch owner-employee to such trust or to or under such plan."

SEC. 4. TAXABILITY OF DISTRIBUTIONS.

(a) EMPLOYEES' ANNUITIES.—Section 72(d)(2) of the Internal Revenue Code of 1954 (relating to employees' annuities) is amended to read as follows:

"(2) SPECIAL RULES FOR APPLICATION OF PARAGRAPH (1).—For purposes of paragraph (1)—

"(A) if the employee died before any amount was received as an annuity under the contract, the words 'receivable by the employee' shall be read as 'receivable by a beneficiary of the employee'; and

"(B) any contribution made with respect to the contract while the employee is an employee within the meaning of section 401(c)(1) which is not allowed as a deduction under section 404 shall be treated as consideration for the contract contributed by the employee."

(b) SPECIAL RULES RELATING TO SELF-EMPLOYED INDIVIDUALS AND OWNER-EMPLOYEES.—Section 72 of the Internal Revenue Code of 1954 (relating to annuities, etc.) is amended by redesignating subsection (m) as subsection (o) and by inserting after subsection (l) the following new subsections:

"(m) SPECIAL RULES APPLICABLE TO EMPLOYEE ANNUITIES AND DISTRIBUTIONS UNDER EMPLOYEE PLANS.—

"(1) CERTAIN AMOUNTS RECEIVED BEFORE ANNUITY STARTING DATE.—Any amounts received under an annuity, endowment, or

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life insurance contract before the annuity starting date which are not received as an annuity (within the meaning of subsection (e)(2)) shall be included in the recipient's gross income for the taxable year in which received to the extent that—

"(A) such amounts, plus all amounts theretofore received under the contract and includible in gross income under this paragraph, do not exceed

"(B) the aggregate premiums or other consideration paid for the contract while the employee was an owner-employee which were allowed as deductions under section 404 for the taxable year and all prior taxable years.

Any such amounts so received which are not includible in gross income under this paragraph shall be subject to the provisions of subsection (e).

"(2) Computation of consideration paid by the employee.—In computing—

"(A) the aggregate amount of premiums or other consideration paid for the contract for purposes of subsection (c)(1)(A) (relating to the investment in the contract),

"(B) the consideration for the contract contributed by the employee for purposes of subsection (d)(1) (relating to employee's contributions recoverable in 3 years), and

"(C) the aggregate premiums or other consideration paid for purposes of subsection (e)(1)(B) (relating to certain amounts not received as an annuity),

any amount allowed as a deduction with respect to the contract under section 404 which was paid while the employee was an employee within the meaning of section 401(c)(1) shall be treated as consideration contributed by the employer, and there shall not be taken into account any portion of the premiums or other consideration for the contract paid while the employee was an owner-employee which is properly allocable (as determined under regulations prescribed by the Secretary or his delegate) to the cost of life, accident, health, or other insurance.

"(3) Life insurance contracts.—

"(A) This paragraph shall apply to any life insurance contract—

"(i) purchased as a part of a plan described in section 403(a), or

"(ii) purchased by a trust described in section 401(a) which is exempt from tax under section 501(a) if the proceeds of such contract are payable directly or indirectly to a participant in such trust or to a beneficiary of such participant.

"(B) Any contribution to a plan described in subparagraph (A)(i) or a trust described in subparagraph (A)(ii) which is allowed as a deduction under section 404, and any income of a trust described in subparagraph (A)(ii), which is determined in accordance with regulations prescribed by the Secretary or his delegate to have been applied to purchase the life insurance protection under a contract described in subparagraph (A), is includible in the gross income of the participant for the taxable year when so applied.

"*(C) In the case of the death of an individual insured under a contract described in subparagraph (A), an amount equal to the cash surrender value of the contract immediately before the death of the insured shall be treated as a payment under such plan or a distribution by such trust, and the excess of the amount payable by reason of the death of the insured over such cash surrender value shall not be includible in gross income under this section and shall be treated as provided in section 101.*

"*(4) Amounts constructively received.*—

"*(A) Assignments or pledges.—If during any taxable year an owner-employee assigns (or agrees to assign) or pledges (or agrees to pledge) any portion of his interest in a trust described in section 401(a) which is exempt from tax under section 501(a) or any portion of the value of a contract purchased as part of a plan described in section 403(a), such portion shall be treated as having been received by such owner-employee as a distribution from such trust or as an amount received under the contract.*

"*(B) Loans on contracts.—If during any taxable year, an owner-employee receives, directly or indirectly, any amount from any insurance company as a loan under a contract purchased by a trust described in section 401(a) which is exempt from tax under section 501(a) or purchased as part of a plan described in section 403(a), and issued by such insurance company, such amount shall be treated as an amount received under the contract.*

"*(5) Penalties applicable to certain amounts received by owner-employees.*—

"*(A) This paragraph shall apply*—

"*(i) to amounts (other than any amount received by an individual in his capacity as a policyholder of an annuity, endowment, or life insurance contract which is in the nature of a dividend or similar distribution) which are received from a qualified trust described in section 401(a) or under a plan described in section 403(a) and which are received by an individual, who is, or has been, an owner-employee, before such individual attains the age of 59½ years, for any reason other than the individual's becoming disabled (within the meaning of section 213(g)(3)), but only to the extent that such amounts are attributable to contributions paid on behalf of such individual (whether or not paid by him) while he was an owner-employee,*

"*(ii) to amounts which are received from a qualified trust described in section 401(a) or under a plan described in section 403(a) at any time by an individual who is, or has been, an owner-employee, or by the successor of such individual, but only to the extent that such amounts are determined, under regulations prescribed by the Secretary or his delegate, to exceed the benefits provided for such individual under the plan formula, and*

"*(iii) to amounts which are received, by an individual who is, or has been, an owner-employee, by reason of the distribution under the provisions of section 401(e)(2)(E) of his entire interest in all qualified trusts described in*

section 401(a) and in all plans described in section 403(a).

"*(B)(i) If the aggregate of the amounts to which this paragraph applies received by any person in his taxable year equals or exceeds $2,500, the increase in his tax for the taxable year in which such amounts are received and attributable to such amounts shall not be less than 110 percent of the aggregate increase in taxes, for the taxable year and the 4 immediately preceding taxable years, which would have resulted if such amounts had been included in such person's gross income ratably over such taxable years.*

"*(ii) If deductions have been allowed under section 404 for contributions paid on behalf of the individual while he is an owner-employee for a number of prior taxable years less than 4, clause (i) shall be applied by taking into account a number of taxable years immediately preceding the taxable year in which the amount was so received equal to such lesser number.*

"*(C) If subparagraph (B) does not apply to a person for the taxable year, the increase in tax of such person for the taxable year attributable to the amounts to which this paragraph applies shall be 110 percent of such increase (computed without regard to this subparagraph).*

"*(D) Subparagraph (A)(ii) of this paragraph shall not apply to any amount to which section 402(a)(2) or 403(a)(2) applies.*

"*(E) For special rules for computation of taxable income for taxable years to which this paragraph applies, see subsection (n)(3).*

"*(6) Owner-employee defined.—For purposes of this subsection, the term 'owner-employee' has the meaning assigned to it by section 401(c)(3).*

"*(n) Treatment of Certain Distributions With Respect to Contributions by Self-Employed Individuals.—*

"*(1) Application of subsection.—*

"*(A) Distributions by employees' trust.—Subject to the provisions of subparagraph (C), this subsection shall apply to amounts distributed to a distributee, in the case of an employees' trust described in section 401(a) which is exempt from tax under section 501(a), if the total distributions payable to the distributee with respect to an employee are paid to the distributee within one taxable year of the distributee—*

"*(i) on account of the employee's death,*

"*(ii) after the employee has attained the age of 59½ years, or*

"*(iii) after the employee has become disabled (within the meaning of section 213(g)(3)).*

"*(B) Annuity plans.—Subject to the provisions of subparagraph (C), this subsection shall apply to amounts paid to a payee, in the case of an annuity plan described in section 403(a), if the total amounts payable to the payee with respect to an employee are paid to the payee within one taxable year of the payee—*

"*(i) on account of the employee's death,*

"*(ii) after the employee has attained the age of 59½ years, or*

"*(iii) after the employee has become disabled (within the meaning of section 213(g)(3)).*

"(C) LIMITATIONS AND EXCEPTIONS.—This subsection shall apply—

"(i) only with respect to so much of any distribution or payment to which (without regard to this subparagraph) subparagraph (A) or (B) applies as is attributable to contributions made on behalf of an employee while he was an employee within the meaning of section 401(c)(1), and

"(ii) if the recipient is the employee on whose behalf such contributions were made, only if contributions which were allowed as a deduction under section 404 have been made on behalf of such employee while he was an employee within the meaning of section 401(c)(1) for 5 or more taxable years prior to the taxable year in which the total distributions payable or total amounts payable, as the case may be, are paid.

This subsection shall not apply to amounts described in clauses (ii) and (iii) of subparagraph (A) of subsection (m)(5) (but, in the case of amounts described in clause (ii) of such subparagraph, only to the extent that subsection (m)(5) applies to such amounts).

"(2) LIMITATION OF TAX.—In any case to which this subsection applies, the tax attributable to the amounts to which this subsection applies for the taxable year in which such amounts are received shall not exceed whichever of the following is the greater:

"(A) 5 times the increase in tax which would result from the inclusion in gross income of the recipient of 20 percent of so much of the amount so received as is includible in gross income, or

"(B) 5 times the increase in tax which would result if the taxable income of the recipient for such taxable year equaled 20 percent of the amount of the taxable income of the recipient for such taxable year determined under paragraph (3)(A).

"(3) DETERMINATION OF TAXABLE INCOME.—Notwithstanding section 63 (relating to definition of taxable income), for purposes only of computing the tax under this chapter attributable to amounts to which this subsection or subsection (m)(5) applies and which are includible in gross income—

"(A) the taxable income of the recipient for the taxable year of receipt shall be treated as being not less than the amount by which (i) the aggregate of such amounts so includible in gross income exceeds (ii) the amount of the deductions allowed for such taxable year under section 151 (relating to deductions for personal exemptions); and

"(B) in making ratable inclusion computations under paragraph (5)(B) of subsection (m), the taxable income of the recipient for each taxable year involved in such ratable inclusion shall be treated as being not less than the amount required by such paragraph (5)(B) to be treated as includible in gross income for such taxable year.

In any case in which the preceding sentence results in an increase in taxable income for any taxable year, the resulting increase in the taxes imposed by section 1 or 3 for such taxable year shall not be

reduced by any credit under part IV of subchapter A (other than section 31 thereof) which, but for this sentence, would be allowable."

(c) *Capital Gains Treatment of Certain Employees' Trust Distributions.—Section 402(a)(2) of the Internal Revenue Code of 1954 (relating to capital gains treatment for certain distributions) is amended by adding at the end thereof the following new sentence: "This paragraph shall not apply to distributions paid to any distributee to the extent such distributions are attributable to contributions made on behalf of the employee while he was an employee within the meaning of section 401(c)(1)."*

(d) *Capital Gains Treatment of Certain Employees' Annuity Payments.—Section 403(a) of the Internal Revenue Code of 1954 (relating to taxability of a beneficiary under a qualified annuity plan) is amended—*

(1) *by striking out in paragraph (2)(A)(i) "which meets the requirements of section 401(a) (3), (4), (5), and (6)" and inserting in lieu thereof "described in paragraph (1)";*

(2) *by adding at the end of paragraph (2)(A) the following new sentence: "This subparagraph shall not apply to amounts paid to any payee to the extent such amounts are attributable to contributions made on behalf of the employee while he was an employee within the meaning of section 401(c)(1)."; and*

(3) *by adding after paragraph (2) the following new paragraph:*

"(3) Self-employed individuals.—For purposes of this subsection, the term 'employee' includes an individual who is an employee within the meaning of section 401(c)(1), and the employer of such individual is the person treated as his employer under section 401(c)(4)."

SEC. 5. PLANS FOR PURCHASE OF UNITED STATES BONDS.

(a) *Qualified Bond Purchase Plans.—Part I of subchapter D of chapter 1 of the Internal Revenue Code of 1954 (relating to deferred compensation, etc.) is amended by adding at the end thereof the following new section:*

"SEC. 405. QUALIFIED BOND PURCHASE PLANS.

"(a) Requirements for Qualification.—A plan of an employer for the purchase for and distribution to his employees or their beneficiaries of United States bonds described in subsection (b) shall constitute a qualified bond purchase plan under this section if—

"(1) the plan meets the requirements of section 401(a) (3), (4), (5), (6), (7), and (8) and, if applicable, the requirements of section 401(a) (9) and (10) and of section 401(d) (other than paragraphs (1), (5)(B), and (8)); and

"(2) contributions under the plan are used solely to purchase for employees or their beneficiaries United States bonds described in subsection (b).

"(b) Bonds to Which Applicable.—

"(1) Characteristics of bonds.—This section shall apply only to a bond issued under the Second Liberty Bond Act, as amended, which by its terms, or by regulations prescribed by the Secretary under such Act—

"(A) provides for payment of interest, or investment yield, only upon redemption;

"(B) *may be purchased only in the name of an individual;*

"(C) *ceases to bear interest, or provide investment yield, not later than 5 years after the death of the individual in whose name it is purchased;*

"(D) *may be redeemed before the death of the individual in whose name it is purchased only if such individual—*

"(i) *has attained the age of 59½ years, or*

"(ii) *has become disabled (within the meaning of section 213(g)(3)); and*

"(E) *is nontransferable.*

"(2) MUST BE PURCHASED IN NAME OF EMPLOYEE.—*This section shall apply to a bond described in paragraph (1) only if it is purchased in the name of the employee.*

"(c) DEDUCTION FOR CONTRIBUTIONS TO BOND PURCHASE PLANS.—*Contributions paid by an employer to or under a qualified bond purchase plan shall be allowed as a deduction in an amount determined under section 404 in the same manner and to the same extent as if such contributions were made to a trust described in section 401(a) which is exempt from tax under section 501(a).*

"(d) TAXABILITY OF BENEFICIARY OF QUALIFIED BOND PURCHASE PLAN.—

"(1) GROSS INCOME NOT TO INCLUDE BONDS AT TIME OF DISTRIBUTION.—*For purposes of this chapter, in the case of a distributee of a bond described in subsection (b) under a qualified bond purchase plan, or from a trust described in section 401(a) which is exempt from tax under section 501(a), gross income does not include any amount attributable to the receipt of such bond. Upon redemption of such bond, the proceeds shall be subject to taxation under this chapter, but the provisions of section 72 (relating to annuities, etc.) and section 1232 (relating to bonds and other evidences of indebtedness) shall not apply.*

"(2) BASIS.—*The basis of any bond received by a distributee under a qualified bond purchase plan—*

"(A) *if such bond is distributed to an employee, or with respect to an employee, who at the time of purchase of the bond, was an employee other than an employee within the meaning of section 401(c)(1), shall be the amount of the contributions by the employee which were used to purchase the bond, and*

"(B) *if such bond is distributed to an employee, or with respect to an employee, who, at the time of purchase of the bond, was an employee within the meaning of section 401(c)(1), shall be the amount of the contributions used to purchase the bond which were made on behalf of such employee and were not allowed as a deduction under subsection (c).*

The basis of any bond described in subsection (b) received by a distributee from a trust described in section 401(a) which is exempt from tax under section 501(a) shall be determined under regulations prescribed by the Secretary or his delegate.

"(e) CAPITAL GAINS TREATMENT NOT TO APPLY TO BONDS DISTRIBUTED BY TRUSTS.—*Section 402(a)(2) shall not apply to any bond described in subsection (b) distributed to any distributee and, for purposes of applying such section, any such bond distributed to any distributee and any such bond to the credit of any employee shall not be taken into account.*

"(f) *Employee Defined.—For purposes of this section, the term 'employee' includes an individual who is an employee within the meaning of section 401(c)(1), and the employer of such individual shall be the person treated as his employer under section 401(c)(4).*

"(g) *Proof of Purchase.—At the time of purchase of any bond to which this section applies, proof of such purchase shall be furnished in such form as will enable the purchaser, and the employee in whose name such bond is purchased, to comply with the provisions of this section.*

"(h) *Regulations.—The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the provisions of this section.*"

(b) *Clerical Amendment.—The table of sections for such part is amended by adding at the end thereof the following new item:*

"Sec. 405. Qualified bond purchase plans."

SEC. 6. PROHIBITED TRANSACTIONS.

Section 503 of the Internal Revenue Code of 1954 (relating to prohibited transactions) is amended by adding at the end thereof the following new subsection:

"(j) *Trusts Benefiting Certain Owner-Employees.—*

"(1) *Prohibited transactions.—In the case of a trust described in section 401(a) which is part of a plan providing contributions or benefits for employees some or all of whom are owner-employees (as defined in section 401(c)(3)) who control (within the meaning of section 401(d)(9)(B)) the trade or business with respect to which the plan is established, the term 'prohibited transaction' also means any transaction in which such trust, directly or indirectly—*

"(A) *lends any part of the corpus or income of the trust to;*

"(B) *pays any compensation for personal services rendered to the trust to;*

"(C) *makes any part of its services available on a preferential basis to; or*

"(D) *acquires for the trust any property from, or sells any property to;*

any person described in subsection (c) or to any such owner-employee, a member of the family (as defined in section 267(c)(4)) of any such owner-employee, or a corporation controlled by any such owner-employee through the ownership, directly or indirectly, of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of the corporation.

"(2) *Special rule for loans.—For purposes of the application of paragraph (1)(A), the following rules shall apply with respect to a loan made before the date of the enactment of this subsection which would be a prohibited transaction if made in a taxable year beginning after December 31, 1962:*

"(A) *If any part of the loan is repayable prior to December 31, 1965, the renewal of such part of the loan for a period not extending beyond December 31, 1965, on the same terms, shall not be considered a prohibited transaction.*

"(B) *If the loan is repayable on demand, the continuation of the loan beyond December 31, 1965, shall be considered a prohibited transaction.*"

SEC. 7. OTHER SPECIAL RULES, TECHNICAL CHANGES, AND ADMINISTRATIVE PROVISIONS.

(a) Retirement Income Credit.—Section 37(c)(1) of the Internal Revenue Code of 1954 (relating to definition of retirement income) is amended—

(1) by striking out subparagraph (A) and inserting in lieu thereof the following:

"(A) pensions and annuities (including, in the case of an individual who is, or has been, an employee within the meaning of section 401(c)(1), distributions by a trust described in section 401(a) which is exempt from tax under section 501(a)),"; and

(2) by striking out "and" at the end of subparagraph (C), by striking out "or" at the end of subparagraph (D) and inserting in lieu thereof "and", and by adding after subparagraph (D) the following new subparagraph:

"(E) bonds described in section 405(b)(1) which are received under a qualified bond purchase plan described in section 405(a) or in a distribution from a trust described in section 401(a) which is exempt from tax under section 501(a), or".

(b) Adjusted Gross Income.—Section 62 of the Internal Revenue Code of 1954 (relating to the definition of adjusted gross income) is amended by inserting after paragraph (6) the following new paragraph:

"(7) Pension, profit-sharing, annuity, and bond purchase plans of self-employed individuals.—In the case of an individual who is an employee within the meaning of section 401(c)(1), the deductions allowed by section 404 and section 405(c) to the extent attributable to contributions made on behalf of such individual."

(c) Death Benefits.—Section 101(b) of the Internal Revenue Code of 1954 (relating to employees' death benefits) is amended—

(1) by striking out clause (ii) of paragraph (2)(B) and inserting in lieu thereof the following:

"(ii) under an annuity contract under a plan described in section 403(a), or"; and

(2) by adding at the end thereof the following new paragraph:

"(3) Self-employed individual not considered an employee.—For purposes of this subsection, the term 'employee' does not include an individual who is an employee within the meaning of section 401(c)(1) (relating to self-employed individuals)."

(d) Amounts Received Through Accident or Health Insurance.—Section 104(a) of the Internal Revenue Code of 1954 (relating to compensation for injuries or sickness) is amended by adding at the end thereof the following new sentence:

"For purposes of paragraph (3), in the case of an individual who is, or has been, an employee within the meaning of section 401(c)(1) (relating to self-employed individuals), contributions made on behalf of such individual while he was such an employee to a trust described in section 401(a) which is exempt from tax under section 501(a), or under a plan described in section 403(a), shall, to the extent allowed as deductions under section 404, be treated as contributions by the employer which were not includible in the gross income of the employee."

(e) Amounts Received Under Accident and Health Plans.—Section 105 of the Internal Revenue Code of 1954 (relating to amounts

received under accident and health plans) is amended by adding at the end thereof the following new subsection:

"(g) Self-Employed Individual Not Considered an Employee.—For purposes of this section, the term 'employee' does not include an individual who is an employee within the meaning of section 401(c)(1) (relating to self-employed individuals)."

(f) Net Operating Loss Deduction.—Section 172(d)(4) of the Internal Revenue Code of 1954 (relating to nonbusiness deductions of taxpayers other than corporations) is amended—

(1) by striking out "and" at the end of subparagraph (B);

(2) by striking out the period at the end of subparagraph (C) and inserting "; and"; and

(3) by adding after subparagraph (C) the following new subparagraph:

"(D) any deduction allowed under section 404 or section 405(c) to the extent attributable to contributions which are made on behalf of an individual who is an employee within the meaning of section 401(c)(1) shall not be treated as attributable to the trade or business of such individual."

(g) Certain Life Insurance Reserves.—Section 805(d)(1) of the Internal Revenue Code of 1954 (relating to pension plan reserves) is amended—

(1) by striking out in subparagraph (B) "meeting the requirements of section 401(a) (3), (4), (5), and (6) or" and inserting in lieu thereof "described in section 403(a); or plans meeting"; and

(2) by striking out in subparagraph (C) "and (6)" and inserting in lieu thereof "(6), (7), and (8)".

(h) Unincorporated Businesses Electing To Be Taxed as Corporations.—Section 1361(d) of the Internal Revenue Code of 1954 (relating to unincorporated business enterprises electing to be taxed as domestic corporations) is amended by inserting before the period at the end thereof the following: "other than an employee within the meaning of section 401(c)(1) (relating to self-employed individuals), or for purposes of section 405 (relating to qualified bond purchase plans) other than an employee described in section 405(f)".

(i) Estate Tax Exemption of Employees' Annuities.—Section 2039 of the Internal Revenue Code of 1954 (relating to exemption from the gross estate of annuities under certain trusts and plans) is amended—

(1) by striking out in subsection (c)(2) "met the requirements of section 401(a) (3), (4), (5), and (6)" and inserting "was a plan described in section 403(a)"; and

(2) by adding at the end of subsection (c) the following new sentence: "For purposes of this subsection, contributions or payments on behalf of the decedent while he was an employee within the meaning of section 401(c)(1) made under a trust or plan described in paragraph (1) or (2) shall be considered to be contributions or payments made by the decedent."

(j) Gift Tax Exemption of Employees' Annuities.—Section 2517 of the Internal Revenue Code of 1954 (relating to exclusion from gift tax in case of certain annuities under qualified plans) is amended—

(1) by striking out in subsection (a)(2) "met the requirements of section 401(a) (3), (4), (5), and (6)" and inserting in lieu thereof "was a plan described in section 403(a)"; and

(2) by adding at the end of subsection (b) the following new sentence: "For purposes of this subsection, payments or contributions on behalf of an individual while he was an employee within the meaning of section 401(c)(1) made under a trust or plan described in subsection (a) (1) or (2) shall be considered to be payments or contributions made by the employee."

(k) Federal Unemployment Tax Act.—Section 3306(b)(5) of the Internal Revenue Code of 1954 (relating to definition of wages) is amended by striking out subparagraph (B) and inserting in lieu thereof the following new subparagraphs:

"(B) under or to an annuity plan which, at the time of such payment, is a plan described in section 403(a), or

"(C) under or to a bond purchase plan which, at the time of such payment, is a qualified bond purchase plan described in section 405(a);".

(l) Withholding of Income Tax.—Section 3401(a)(12) of the Internal Revenue Code of 1954 (relating to definition of wages) is amended by striking out subparagraph (B) and inserting in lieu thereof the following new subparagraphs:

"(B) under or to an annuity plan which, at the time of such payment, is a plan described in section 403(a); or

"(C) under or to a bond purchase plan which, at the time of such payment, is a qualified bond purchase plan described in section 405(a)."

(m) Information Requirements.—

(1) In general.—Subpart B of part III of subchapter A of chapter 61 of the Internal Revenue Code of 1954 (relating to information concerning transactions with other persons) is amended by adding after section 6046 the following new section:

"SEC. 6047. INFORMATION RELATING TO CERTAIN TRUSTS AND ANNUITY AND BOND PURCHASE PLANS.

"(a) Trustees and Insurance Companies.—The trustee of a trust described in section 401( ) which is exempt from tax under section 501(a) to which contributions have been paid under a plan on behalf of any owner-employee (as defined in section 401(c)(3)), and each insurance company or other person which is the issuer of a contract purchased by such a trust, or purchased under a plan described in section 403(a), contributions for which have been paid on behalf of any owner-employee, shall file such returns (in such form and at such times), keep such records, make such identification of contracts and funds (and accounts within such funds), and supply such information, as the Secretary or his delegate shall by forms or regulations prescribe.

"(b) Owner-Employees.—Every individual on whose behalf contributions have been paid as an owner-employee (as defined in section 401(c)(3))—

"(1) to a trust described in section 401(a) which is exempt from tax under section 501(a), or

"(2) to an insurance company or other person under a plan described in section 403(a),

shall furnish the trustee, insurance company, or other person, as the case may be, such information at such times and in such form and manner as the Secretary or his delegate shall prescribe by forms or regulations.

"(c) *Employees Under Qualified Bond Purchase Plans.*—*Every individual in whose name a bond described in section 405(b)(1) is purchased by his employer under a qualified bond purchase plan described in section 405(a), or by a trust described in section 401(a) which is exempt from tax under section 501(a), shall furnish*—

"(1) *to his employer or to such trust, and*

"(2) *to the Secretary (or to such person as the Secretary may by regulations prescribe),*

such information as the Secretary or his delegate shall by forms or regulations prescribe.

"(d) *Cross Reference.*—

"For criminal penalty for furnishing fraudulent information, see section 7207."

(2) *Clerical amendment.*—*The table of sections for such subpart B is amended by adding after the reference to section 6046 the following:*

"Sec. 6047. Information relating to certain trusts and annuity and bond purchase plans."

(3) *Penalty.*—*Section 7207 of the Internal Revenue Code of 1954 (relating to fraudulent returns, statements, or other documents) is amended by adding at the end thereof the following new sentence: "Any person required pursuant to section 6047 (b) or (c) to furnish any information to the Secretary or any other person who willfully furnishes to the Secretary or such other person any information known by him to be fraudulent or to be false as to any material matter shall be fined not more than $1,000, or imprisoned not more than 1 year, or both."*

SEC. 8. EFFECTIVE DATE.

The amendments made by this Act shall apply to taxable years beginning after December 31, 1961.

And the Senate agree to the same.

W. D. Mills,
Hale Boggs,
Eugene J. Keogh,
Noah Mason,
John W. Byrnes,
Howard H. Baker,
Managers on the Part of the House.

Harry F. Byrd,
Robt. S. Kerr,
Russell B. Long,
Geo. A. Smathers,
John J. Williams,
Frank Carlson,
Wallace F. Bennett,
Managers on the Part of the Senate.

STATEMENT OF THE MANAGERS ON THE PART OF THE HOUSE

The managers on the part of the House at the conference on the disagreeing votes of the two Houses on the amendment of the Senate to the bill (H.R. 10) to encourage the establishment of voluntary pension plans by self-employed individuals submit the following statement in explanation of the effect of the action agreed upon by the conferees and recommended in the accompanying conference report:

The Senate amendment struck out all of the text of the bill as passed by the House and inserted new text. Under the conference agreement, the House recedes from its disagreement to the Senate amendment and agrees to the same with an amendment which inserts new text in the nature of a substitute. The important differences between the bill as passed by the House, the Senate amendment, and the conference substitute are explained below.

Time of payment of benefits under a qualified plan.—The bill as passed by the House provided (in proposed sec. 401(a)(8)) that no trust was to constitute a qualified trust under section 401 unless the entire interest of the employee will be distributed to him not later than the taxable year in which he attains age 70½ or, in the case of an employee other than an owner-employee, a later taxable year in which he retires. An alternative method was provided in which the distribution must begin not later than the taxable year specified in the preceding sentence and must be completed within a period based on the life, or life expectancy, of the employee or of the employee and his spouse.

The Senate amendment (in proposed sec. 401(a)(9)) makes the above rules applicable only in the case of a trust providing contributions or benefits for employees some or all of whom are self-employed individuals or are owner-employees, including corporate owner-employees. The conference substitute inserts a new paragraph (9) in section 401(a) which makes the above rules applicable in the case of a trust providing contributions or benefits for employees some or all of whom are self-employed individuals.

The Senate amendment, and the conference substitute, contain a provision that these new rules will not apply to any distribution under a designation of a method of distribution, where such designation was made by the employee before the date of the enactment of the bill.

Coverage requirements where plan benefits an owner-employee.—The bill as passed by the House (proposed sec. 401(a)(10)) provided that those plans providing for current or future contributions for an owner-employee who has, or has had, more than three employees had to include all employees having more than 3 years of service, other than part-time or seasonal employees. In a case where the owner-employee has less than four employees, the bill as passed by the House provided that coverage for such other employees was discretionary.

The Senate amendment and the conference substitute provide (see proposed sec. 401(d)(3)) that any plan which benefits an owner-employee must provide benefits for all employees with three or more years of service, other than part-time or seasonal employees.

Self-employment earnings.—The bill as passed by the House provided that a proprietor or partner may be covered under a qualified retirement plan if he has "self-employment earnings," and that such earnings are the basis for determining the amount of the deduction for contributions for self-employed persons. In general, the term "self-employment earnings" was defined (in proposed sec. 401(c)(3)) to mean net earnings from a trade or business of a self-employed individual, thus including return on capital invested in the trade or business, as well as income for personal services.

Under the Senate amendment and the conference substitute, coverage under the bill depends on "earned income", and such income is the basis for computing deductible contributions for self-employed individuals. This term (see proposed sec. 401(c)(2)) means, in general, net earnings from self-employment to the extent such earnings constitute earned income within the meaning of section 911(b) of the 1954 code (such as professional fees and other compensation for personal services). Where personal services and invested capital are material income-producing factors, the term "earned income" means not more than 30 percent of the net profits from the business, but, in those cases in which the self-employed person renders full-time personal services, not less than the first $2,500 of such net profits.

Definition of owner-employee.—Certain of the provisions of the bill are applicable to owner-employees or to plans covering owner-employees. The bill as passed by the House provided (in proposed sec. 401(c)(4)) that an owner-employee means a self-employed individual who derives self-employment earnings from a trade or business carried on by him or who is a partner who owns more than 10 percent of either the capital interest or the profits interest in the partnership.

The Senate amendment (see proposed sec. 401(c)(3)) included in the definition of an owner-employee (in addition to proprietors and more than 10 percent partners) corporate employees who own more than 10 percent of the value or voting power of the stock of a corporation. Plans covering these corporate employees therefore would have become subject to the new requirements for qualification of retirement plans covering owner-employees and the limitations on the amount deductible with respect to contributions made on behalf of owner-employees. The definition of owner-employee in the conference substitute (see proposed sec. 401(c)(3)) does not include the corporate employees described in the preceding sentences.

Constructive ownership rules.—The Senate amendment added a new provision to the bill (proposed sec. 401(c)(5)) containing rules of constructive ownership for purposes of section 401 of the 1954 code. In general, an individual would have been treated as constructively owning any interest in an unincorporated trade or business or in a corporation which is owned, directly or indirectly, by his spouse, minor children, or ancestors. The conference substitute eliminates these constructive ownership rules.

Requirement that trustee be a bank.—The bill as passed by the House provided (in proposed sec. 401(d)(1)) that the trustee of an exempt employees' trust under a plan providing contributions or

benefits for owner-employees must be a bank or other specified financial institution, but that another person (who may be the employer) could be given power to control investments of the trust fund.

The Senate amendment and the conference substitute (see proposed sec. 401(d)(1)) retain this provision, but provide that a trust which exclusively uses annuity, endowment, or life insurance contracts of a life insurance company to fund the benefits prescribed by the trust is excepted from the requirement that a bank or other specified financial institution be the trustee of the retirement funds. The Secretary of the Treasury or his delegate is authorized to prescribe by regulations the extent to which this exception will apply and the information which the insurance company must furnish regarding trust transactions.

Consent to be covered.—The Senate amendment and the conference substitute provide (in proposed sec. 401(d)(4)(A)) that an owner-employee, to be covered by a plan established for the trade or business of which he is an owner-employee, must consent to such coverage.

Vesting.—The bill as passed by the House (see proposed sec. 401(d)(3)) required immediate vesting of the employee's rights under the plan of an owner-employee with more than 3 employees.

The Senate amendment and the conference substitute provide (see proposed sec. 401(d)(2)(A)) that any plan providing contributions or benefits for an owner-employee must provide for immediate vesting of the rights of the other employees covered by the plan.

Integration with social security of qualified plans covering owner-employees.—Under present law, a plan is not considered discriminatory merely because the contributions or benefits under the plan are integrated with retirement benefits under social security. The rules relating to the integration of qualified plans with social security now assume that the employer has paid for that portion of the social security benefit of his employees which the employees themselves have not paid for. The bill as passed by the House provided (see proposed sec. 401(d)(5)(B)) that integration with social security was permitted for plans covering owner-employees with more than three employees only if contributions for the owner-employees did not exceed one-third of the total deductible contributions. Furthermore, the owner-employee was given credit only for his actual social security contributions on behalf of his other employees.

The Senate amendment and conference substitute retain (see proposed sec. 401(d)(6)) the rules of the bill as passed by the House, but provide that such rules are applicable to all plans which provide contributions or benefits for any owner-employee (whether or not more than 3 employees are covered under the plan).

Distributions after death.—The bill as passed by the House provided (see proposed sec. 401(d)(7)) that, after the death of an owner-employee, his remaining interest in the plan must, in general, either be distributed to his beneficiary within 5 years, or used within that period to purchase an immediate annuity for his beneficiary.

The Senate amendment and conference substitute retain (see proposed sec. 401(d)(7)) the provisions of the bill as passed by the House, but provide that they shall not apply if a distribution has commenced and such distribution is for a term certain over a period not extending beyond the life expectancy of the owner-employee and his spouse.

Two or more businesses.—The bill as passed by the House provides (see proposed sec. 401(d)(9)) that an owner-employee (or a group of two or more owner-employees) who controls more than one business would be required to group together all controlled businesses for the purpose of determining whether the rules relating to the qualification of the plan would be those which apply to owner-employees with 3 or fewer employees or those applicable to owner-employees with more than 3 employees.

The Senate amendment and conference substitute retain (see proposed sec. 401(d)(9)) the principle contained in the bill as passed by the House. However, the Senate amendment and conference substitute provide the same requirements for the qualification of all plans covering an owner-employee. Thus, for example, under the Senate amendment and conference substitute, any owner-employee (or any group of two or more owner-employees) who controls more than one business will be required to group together all controlled businesses for the purpose of determining whether the coverage requirements are met as to all the employees.

In addition, the Senate amendment and the conference substitute provide (see proposed sec. 401(d)(10)) that an individual who is an owner-employee in a business (whether or not he controls the business) and is also an owner-employee of another business which he controls may not be covered under the plan of the first business unless he has established a plan for the employees of the business which he controls. The plan for the business which he controls must provide contributions and benefits for employees which are at least as favorable as the contributions and benefits provided for owner-employees under the plan of the first business.

Excess contribution.—The bill as passed by the House provided (see proposed sec. 401(e)) certain rules where excess contributions are made under a qualified plan covering an owner-employee.

In general, the Senate amendment and the conference substitute incorporate the provisions of the bill as passed by the House relating to such excess contributions. Thus, an excess contribution is defined as an amount greater than the permitted deductible and nondeductible contributions made on behalf of the owner-employee (computed without regard to the special limitation which allows as a deduction only one-half of the deductible amount determined under sec. 404(e)). However, the Senate amendment and the conference substitute provide that, in the case of multiple plans, the amount of any contribution made by an owner-employee, as an employee, under all such plans which exceeds $2,500 is an excess contribution. The Senate amendment and the conference substitute also make it clear that, when an excess contribution must be returned to the owner-employee on whose behalf it was made, the income attributable to such excess contribution which is required to be returned to the owner-employee is the net income so attributable.

In addition, the Senate amendment and the conference substitute provide (see proposed sec. 401(e)(3)) an exception to the definition of an excess contribution under which an owner-employee is permitted to purchase annuity, life insurance, or endowment policies on his life from an insurance company at level premiums without fear of making an excess contribution. Under this exception, an owner-employee is permitted, in general, to contribute each year toward the purchase

price of his policy up to an amount equal to the amount he would have been allowed to contribute on the basis of his average earned income for 3 years preceding issuance of the last such policy under the plan. However, this provision does not affect the amount which is allowed as a deduction under section 404. Moreover, this exception is limited so that under no circumstances could the owner-employee obtain under one or more retirement plans level-premium policies requiring annual payments of more than $2,500.

Custodial accounts.—The bill as passed by the House (see proposed sec. 401(f)) modified the provisions of existing law which require a plan described in section 401 to use a trust. The bill as passed by the House provided that a custodial account could be used in lieu of a trust, if its investments are made solely in a regulated investment company which issues only redeemable stock and the custodian of the account was a bank as defined in section 581 of the code.

The Senate amendment and the conference substitute retain the provisions of the bill as passed by the House, but also permit the funds of the custodial account to be invested solely in annuity, endowment, or life insurance policies issued by an insurance company. In addition, the Senate amendment and the conference substitute provide that the custodian of such accounts can be any of the banking corporations described in the new section 401(d)(1) of the code.

Annuity defined.—The bill as passed by the House provided (see proposed sec. 401(g)) that the term "annuity" as used in sections 401–404 of the code included a face amount certificate which is nontransferable.

The Senate amendment and the conference substitute retain the provision of the bill as passed by the House and, in addition, provide that the term "annuity" as used in such sections does not include any contract or certificate issued after December 31, 1962, which is transferable, except where such contract or certificate is owned by a trustee of a qualified plan.

Deductible contributions.—The bill as passed by the House provided (see proposed sec. 404(e)) for limitations on the amount of deductible contributions which may be made by, or for, an owner-employee covered by a qualified plan. Under the bill as passed by the House, if the owner-employee has, or had, more than three employees, he was permitted to contribute and deduct for himself up to the same proportion of his covered income as his contributions for employees under the plan bear to their compensation. There was no maximum dollar limitation on the contributions which could be made under a plan or plans. If the owner-employer has fewer than four employees, the maximum amount deductible each year for contributions for the owner-employee was 10 percent of his self-employment income or $2,500, whichever is lesser, regardless of the number of plans such owner-employee participated in.

The Senate amendment and the conference substitute provide (see proposed sec. 404(e)) that the 10-percent $2,500 limitation is applicable regardless of the number of employees, or the number of plans, the owner-employee has. Thus, the Senate amendment and the conference substitute place the same limitation on all owner-employees, regardless of whether they have more than three employees. In addition, the Senate amendment and the conference substitute provide that the 10-percent $2,500 limitation is applicable to all self-employed individuals regardless of their ownership-interest.

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The Senate amendment and the conference substitute also provide (see proposed sec. 404(a)(10)) that the deduction which will be allowed to self-employed individuals is one-half of the otherwise deductible contributions which may be made. Thus, if 10 percent of a self-employed individual's earned income from the trade or business with respect to which the plan is established is $2,000, then the amount allowed as a deduction is one-half of that sum, or $1,000, and the other $1,000 is not allowed as a deduction.

The Senate amendment also applied the limitations and rules described above to contributions made on behalf of owner-employees of corporations. The conference substitute does not contain any such provisions.

Tax treatment of certain lump-sum distributions.—The bill as passed by the House provided (in proposed sec. 72(n)) special averaging rules for the taxing of the portion of any lump-sum distribution which is derived from contributions on behalf of any self-employed person. In general, under such rules, the tax the self-employed individual would pay with respect to such distribution is limited to five times the increment in tax resulting from including one-fifth of the amount distributed in his gross income for the year in which the distribution was received.

The Senate amendment retained the provisions of the bill as passed by the House, but applied such provisions to lump-sum distributions from all qualified plans (including all existing plans) in place of the capital gains treatment provided by present law. The conference substitute retains the averaging provisions of the bill as passed by the House, without extending their application beyond self-employed individuals.

Elimination of capital gains treatment.—The Senate amendment (see sec. 8 of the bill as passed by the Senate) repealed the provisions of existing law which give capital gains treatment to lump-sum distributions from qualified employees' trusts and under qualified employees' plans. The conference substitute does not contain these provisions of the Senate amendment.

Limitations on employer contributions for employees.—The Senate amendment (see proposed sec. 404(a)(11), as added by sec. 9 of the bill as passed by the Senate) also amended existing law to provide certain limitations on the annual and lifetime contributions made for any employee under a qualified plan or plans which may be deducted by his employer. The conference substitute does not contain any such limitations.

Effective date.—The bill as passed by the House provided that the amendments made by the bill applied to taxable years beginning after December 31, 1961.

The Senate amendment and the conference substitute provide that the amendments made by the bill shall apply to taxable years beginning after December 31, 1962.

W. D. Mills,
Hale Boggs,
Eugene J. Keogh,
Noah Mason,
John W. Byrnes,
Howard H. Baker,
Managers on the Part of the House.

[H.R. 11970] [1]

TRADE EXPANSION ACT OF 1962

[House Report No. 1818, Eighty-seventh Congress, Second Session]

[June 12, 1962]

Mr. Mills, from the Committee on Ways and Means submitted the following report to accompany H.R. 11970.

The Committee on Ways and Means, to whom was referred the bill (H.R. 11970) to promote the general welfare, foreign policy, and security of the United States through international trade agreements and through adjustment assistance to domestic industry, agriculture, and labor, and for other purposes, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

*   *   *   *   *   *   *

V. GENERAL DESCRIPTION OF THE BILL

*   *   *   *   *   *   *

F. POSTAGREEMENT SAFEGUARDS—ADJUSTMENT ASSISTANCE

The bill provides for adjustment assistance to industries, firms, and workers who may be affected by increased imports resulting from trade agreement concessions.

In the case of industries which are seriously injured, or threatened with serious injury, authority is given to adjust tariffs or to impose additional import restrictions (e.g., quotas), or both. Authority is also provided to give other assistance to the firms and workers of such industry. The form of assistance given may thus be tariff adjustment for the industry as a whole, adjustment assistance to firms, adjustment assistance to workers, or any one or more of such forms of assistance.

Adjustment assistance (other than tariff adjustment) may be given in the case of injury to particular firms or workers even though there is no injury to the industry as a whole.

*   *   *   *   *   *   *

5. Assistance to firms

The bill provides that firms determined to be eligible to apply for adjustment assistance may receive, upon application, any or all of three forms of assistance—financial, technical, or tax.

*   *   *   *   *   *   *

Firms with current losses due predominantly to import competition may be given the opportunity to carry back the loss for income tax purposes for 5 years instead of the normal 3 (sec. 311).

(*a*) *Adjustment proposals.*—The bill provides that a firm certified as eligible to apply for trade adjustment assistance may file its application with the Secretary of Commerce, indicating its need for assistance. Within a reasonable time, it must submit a proposal for its economic adjustment. This adjustment proposal will describe in some detail the nature and cost of the proposed adjustment effort, and the resources to be devoted to it from Federal and other sources. The firm may be furnished technical assistance in order to prepare an adequate adjustment proposal.

Adjustment proposals from firms applying for adjustment assistance are to be certified by the Secretary of Commerce as (1) giving reasonable assurance of contributing to successful adjustment; (2) giving adequate consideration to the interest of workers involved; and (3) assuring a maximum self-help effort by the firm. No financial or tax assistance and no further technical assistance may be given until the adjustment proposal has been certified.

With respect to the first point mentioned above, it is recognized that there may be some firms for which adjustment assistance is inappropriate and which could not adjust to their difficulties in this way. Even though such firms may have been certified as eligible to apply for adjustment assistance, the Secretary

[1] Public Law 87–794, page 107, this Bulletin.

of Commerce should not authorize assistance unless he is satisfied that it will be of practical benefit to the applicant. Adjustment assistance should be treated not as indemnification of past losses, but as constructive aid for the rehabilitation of a commercial enterprise. With respect to the second point, adjustment plans that would permit the rehiring of workers laid off due to increased imports resulting from trade agreement concessions are to be preferred (sec. 311).

(*b*) *Use of other agencies*.—The Secretary of Commerce will be required to submit each firm's certified adjustment proposal to whatever Federal agency or agencies he determines to be appropriate to furnish the financial and technical assistance necessary to carry out such proposal. Such agencies may include the Small Business Administration, the Departments of Agriculture and Interior and the Area Redevelopment Administration. Each such agency will determine whether any part of the assistance called for by the proposal comes within the legal authority, regulations, and policies of the agency, and whether it is prepared to furnish such assistance out of its own appropriations. If the agency, for any reason, is not prepared to furnish any or all the necessary assistance, it will promptly notify the Secretary of Commerce, who may then furnish such assistance as remains necessary to carry out the adjustment proposal. The Secretary will, to the maximum extent practicable, provide such financial and technical assistance through existing agencies having the necessary expertise, by making available to them funds appropriated under the bill (sec. 312).

(*c*) *Authority of the Secretary of Commerce*.—The terms and conditions under which the Secretary of Commerce may furnish technical and financial assistance not furnished under the programs of other agencies are comparable to those presently applicable to other Federal assistance programs.

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(*iii*) *Tax assistance*.—The bill authorizes the Secretary of Commerce to certify eligibility for assistance when he determines that such assistance will materially help the firm to adjust and that the firm has sustained a loss which arose predominantly from a business seriously injured, in the loss year, due to increased imports resulting from a trade agreement concession. The existence and amount of such loss are to be determined under the Internal Revenue Code. This will permit a firm to carry back the loss for tax purposes 2 years beyond the 3 years normally allowed. A firm without sufficient profits for the 3 taxable years preceding the loss year to take full advantage of the present carryback provisions, may receive a refund out of taxes for the 2 additional preceding years. Under present law it would only be able to get a tax advantage of the loss against possible future income (sec. 317).

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VI—TECHNICAL EXPLANATION OF THE BILL

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TITLE III—TARIFF ADJUSTMENT AND OTHER ADJUSTMENT ASSISTANCE

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Section 317. Tax assistance

Section 317 provides, in general, for an extension of the net operating loss carryback period under section 172 of the Internal Revenue Code of 1954 from 3 years to 5 years for a firm certified for tax assistance by the Secretary of Commerce.

Section 317(a) provides that the Secretary of Commerce is to certify that a firm is eligible for the extended carryback if the three conditions provided in paragraphs (1), (2), and (3) are satisfied.

Paragraph (1) of section 317(a) relates to the application by a firm for tax assistance. In order to be eligible to apply for the 5-year carryback, a firm must first have had a proposal for its economic adjustment certified by the Secretary of Commerce pursuant to section 311 of the bill, and the application for tax assistance must be made in order to carry out such proposal. In its application for tax assistance, the firm must allege that it has sustained a net operating loss for a taxable year. The application must be submitted to the Secretary of Commerce within 24 months after the close of such taxable year.

The requirement of paragraph (2) of section 317(a) is satisfied only if the Secretary of Commerce determines that the net operating loss arose predominantly out of carrying on a trade or business which was seriously injured, during the year of the loss, by increased imports which the Tariff Commission has determined to result from concessions granted under trade agreements. This determination would be automatic where the firm carries on only one trade or business and where the Secretary of Commerce finds serious import injury to the firm in the loss year. Where more than one trade or business is carried on, however, the carryback (which is computed by combining all trades or businesses of the firm) would be available only if the Secretary of Commerce determined that the loss arose predominantly (that is, more than 50 percent) out of carrying on the import-injured trade or business.

The requirement of paragraph (3) of section 317(a) is satisfied only if the Secretary of Commerce finds that the 5-year carryback will materially contribute to the economic adjustment of the firm. It is intended that such a finding would be made only where substantially all of the refund (or refunds) resulting from the extended carryback will be used to carry out the economic adjustment of the firm in accordance with the adjustment proposal.

The last sentence of section 317(a) makes it clear that the determination or certification by the Secretary of Commerce is not determinative of either the existence or amount of any net operating loss for purposes of section 172 of the Internal Revenue Code of 1954.

Section 317(b) amends section 172(b) of the 1954 Code, relating to net operating loss carrybacks and carryovers, to provide an exception to the general statutory rule that net operating losses are to be carried back 3 years. As amended, paragraph (1)(B) of section 172(b) will (subject to the requirements of sec. 172(b)(3)) extend to five the number of years to which a net operating loss is to be carried back by a firm certified under section 317(a) of the bill. No change is made in the 5-year carryover provision of present subparagraph (B) of section 172(b)(1) except to redesignate such subparagraph as subparagraph (C).

The 5-year carryback will be available only with respect to net operating losses incurred in taxable years ending on or after December 31, 1962. Where the 5-year carryback applies to a net operating loss, such loss is to be carried back in its entirety to the fifth year preceding the taxable year of the loss and then carried in successive order to each of the other taxable years to which it may be carried.

The carryback or the carryover to any one of such other taxable years, and the taxable income of each of the taxable years through which such loss is carried, will be determined in the manner prescribed in paragraph (2) of section 172(b) of the 1954 Code. No changes (other than conforming amendments) have been made to such paragraph (2).

Paragraph (3) of section 172(b) of the 1954 Code provides special rules for applying the 5-year carryback of new section 172(b)(1)(B). Subparagraph (A) of new section 172(b)(3) imposes two conditions. If the two conditions have been satisfied, the 5-year carryback is to apply and the 3-year carryback is not to apply for the taxable year of the loss.

The first condition, provided under clause (i) of section 172(b)(3)(A) of the 1954 Code, relates to two filing requirements. The firm must file, with the Secretary of the Treasury or his delegate, a notice indicating that it has applied to the Secretary of Commerce for tax assistance. After the certification has been issued by the Secretary of Commerce pursuant to section 317(a) of the bill, the firm receiving it must file a copy of this certification with the Secretary of the Treasury or his delegate. The time and manner of filing both the notice and a copy of the certification are to be prescribed under regulations promulgated by the Secretary of the Treasury or his delegate.

The second condition, provided under clause (ii) of section 172(b)(3)(A) of the 1954 Code, requires the taxpayer to consent in writing to the assessment of any deficiency for any year to the extent attributable to the disallowance of a net operating loss deduction previously allowed with respect to the same net operating loss for which a 5-year carryback is being sought. This assessment period may be extended to any time to which the taxpayer and the Secretary of the Treasury or his delegate may agree. The consent will extend the assessment period even though the assessment of the deficiency would otherwise be prevented by the operation of any law or rule of law at the time of filing the consent. This consent will be required when the Secretary of the Treasury or his delegate

deems it necessary to prevent a possible double recovery of tax on account of the same net operating loss (for example in a case involving res judicata).

Subparagraph (B) of section 172(b)(3) provides that, in the case of (i) a partnership and its partners, and (ii) an electing small business corporation under subchapter S of chapter 1 of the 1954 Code (and the shareholders of such corporation), paragraph (1)(B) of section 172(b) (that is, the 5-year carryback provision) is to apply as determined under regulations prescribed by the Secretary of the Treasury or his delegate.

The 5-year carryback under section 172(b)(1)(B) applies to a net operating loss of a partner or a shareholder in an electing small business corporation under subchapter S only if it arose predominantly (that is, more than 50 percent) from losses in respect of which certifications under section 317 of the bill were filed as provided under section 172(b)(3)(A). If the net operating loss did arise predominantly from losses in respect of which certifications were filed, then the entire net operating loss of the partner or shareholder will be carried back 5 years even though part of the net operating loss is not attributable to such losses. If the net operating loss did not rise predominantly from such losses, then no part of the net operating loss will be carried back 5 years.

If a corporation to which a certification under section 317(a) has been issued was a member of an affiliated group which made or was required to make a consolidated return either for the loss year or for any preceding taxable year, the 5-year carryback will apply only to the extent and subject to the conditions, limitations, and exceptions provided in the regulations which may be prescribed under the authority contained in chapter 6 of the 1954 Code (relating to consolidated returns).

Section 317(c) amends section 6501(h) of the 1954 Code, relating to limitations on assessment and collection of deficiencies in the case of net operating loss carrybacks. Under the amendment, the period for assessing a deficiency which is attributable to the application to the taxpayer of a net operating loss carryback is not to expire before 18 months after the date on which the taxpayer files (in such manner as may be prescribed by the Secretary of the Treasury or his delegate) a copy of the certification issued by the Secretary of Commerce under section 317(a).

Section 317(d) amends section 6511(d)(2)(A) of the 1954 Code, relating to a special period of limitation on credits or refunds with respect to net operating loss carrybacks. Under the amendment, the period within which a claim for credit or refund of an overpayment of tax must be filed by the taxpayer will not expire before the expiration of the sixth month following the month in which the certification provided in section 317(a) is issued to the taxpayer by the Secretary of Commerce.

Tentative carryback adjustments for the fourth and fifth years preceding the taxable year of the net operating loss may be applied for under section 6411 of the 1954 Code. If such application is accompanied by a copy of the certification issued under section 317(a) and if the requirements of section 6411 are complied with, such application will be allowed in the same time and manner as under existing section 6411.

Section 318. Protective provisions

Section 318(a) requires each recipient of adjustment assistance under section 313, 314, or 317 to keep records which fully disclose the amount and disposition of the proceeds, if any, of such adjustment assistance, and which will facilitate an effective audit. The recipient must also keep such other records as the Secretary of Commerce may prescribe.

Section 318(b) provides that the Secretary of Commerce and Comptroller General are to have access, for the purpose of audit and examination, to any books, documents, papers, and records of the recipient pertaining to adjustment assistance under sections 313, 314, and 317.

Section 318(c) prohibits the giving of adjustment assistance under section 313, 314, or 317, to any firm unless the owners, partners, or officers certify to the Secretary of Commerce (1) the names of any attorneys, agents, and other persons engaged by or on behalf of the firm for the purpose of expediting applications for such adjustment assistance, and (2) the fees paid or to be paid to any such person.

Section 318(d) prescribes that no financial assistance is to be provided to any firm under section 314 unless the owners, partners, or officers execute an agreement with respect to hiring or retaining the services of certain individuals hold-

ing positions, or engaging in activities, involving discretion with respect to the provision of such financial assistance. The agreement must bind them and the firm for a period of 2 years after such financial assistance is provided.

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Section 338. Definitions

Section 338 contains definitions of certain terms used in chapter 3 of title III of the bill.

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(10) *State law.*—Paragraph (10) defines "State law" as the unemployment insurance law of a State approved by the Secretary of Labor under section 3304 of the Internal Revenue Code of 1954.

[H.R. 11970] [1]

TRADE EXPANSION ACT OF 1962

[Conference Report No. 2518, Eighty-seventh Congress, Second Session]

[October 2, 1962]

Mr. Mills, from the committee of conference, submitted the following conference report to accompany H.R. 11970.

The committee of conference on the disagreeing votes of the two Houses on the amendments of the Senate to the bill (H.R. 11970) to promote the general welfare, foreign policy, and security of the United States through international trade agreements and through adjustment assistance to domestic industry, agriculture, and labor, and for other purposes, having met after full and free conference, have agreed to recommend and do recommend to their respective Houses as follows:

* * * * * * *

That the House recede from its disagreement to the amendment of the Senate numbered 74, and agree to the same with amendments as follows:

Page 42, of the House engrossed bill, strike out line 9 and all that follows through line 3 on page 43, and insert:

(*b*) *Effective with respect to net operating losses for taxable years ending after December 31, 1955, subsection* (*b*) *of section 172 of the Internal Revenue Code of 1954* (*relating to net operating loss carrybacks and carryovers*) *is amended to read as follows:*

(b) Net Operating Loss Carrybacks and Carryovers.—

(1) Years to which loss may be carried.—

(*A*) (*i*) *Except as provided in clause* (*ii*), *a net operating loss for any taxable year ending after December 31, 1957, shall be a net operating loss carryback to each of the 3 taxable years preceding the taxable year of such loss.*

(*ii*) *In the case of a taxpayer with respect to a taxable year ending on or after December 31, 1962, for which a certification has been issued under section 317 of the Trade Expansion Act of 1962, a net operating loss for such taxable year shall be a net operating loss carryback to each of the 5 taxable years preceding the taxable year of such loss.*

(*B*) *Except as provided in subparagraph* (*C*), *a net operating loss for any taxable year ending after December 31, 1955, shall be a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss.*

(*C*) *In the case of a taxpayer which is a regulated transportation corporation* (*as defined in subsection* (*j*) (*1*)), *a net operating loss for any taxable year ending after December 31, 1955, shall* (*except as provided in subsection* (*j*)) *be a net operating loss carryover to each of the 7 taxable years following the taxable year of such loss.*

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[1] Public Law 87–794, page 107, this Bulletin.

REVENUE ACT OF 1962

Table of Contents of House of Representatives Report No. 1447

For table of contents for technical explanation of the bill, see page 501.

For table of contents for separate views of the Republicans on H.R. 10650, and for further views of Hon. Thomas B. Curtis, see page 670.

[H.R. 10650] [1]

REVENUE ACT OF 1962

[House of Representatives Report No. 1447, Eighty-seventh Congress, Second Session]

[March 16, 1962]

MR. MILLS, from the Committee on Ways and Means, submitted the following report to accompany H.R. 10650.

The Committee on Ways and Means, to whom was referred the bill (H.R. 10650) to amend the Internal Revenue Code of 1954 to provide a credit for investment in certain depreciable property, to eliminate certain defects and inequities, and for other purposes, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

I. GENERAL STATEMENT

This bill, H.R. 10650, represents a major revision and reform of our Federal tax system.

On the one hand the investment credit provided by this bill is designed to provide a stimulant to the economic growth of this country. This is needed both to improve our competitive position abroad and in the long run to raise our standard of living at home. On the other hand, the other provisions of this bill are designed to improve the equity of our tax structure.

Estimates presented in part II of this report indicate that when the provisions of this bill are fully effective a revenue loss of from $505 million to $775 million is expected, if no effect of the provisions on the national economy is taken into account. The Treasury Department has estimated, however, that when this effect is taken into account the bill will be substantially in balance.

On April 20, 1961, the President sent to Congress a message containing a series of proposals for the revision of the present tax laws. Most of his recommendations, modified as your committee believed desirable, are incorporated in this bill.

[1] Public Law 87-834, page 111, this Bulletin.

Your committee on May 3, 1961, began hearings on the President's proposals. These hearings extended over 6 weeks and the committee received testimony and comments from over 400 individuals and organizations. This material is contained in 4 volumes of over 3,600 printed pages. Following the special hearings, your committee considered the President's proposal in executive session last year for a period of several weeks. Upon completion of its considerations at that time your committee made certain *tentative* decisions for incorporation in a draft made public in order to obtain the views of interested persons. The committee print containing these suggestions was released to the public on August 24, 1961, together with a general explanation of these provisions. That print was given wide distribution. In the fall of 1961 the staff met with outside persons and worked with the Treasury Department in obtaining the views of interested parties. With the beginning of this session of Congress your committee immediately began a review of these provisions, making modifications in the earlier decisions to take into account the suggestions and recommendations received. This bill, therefore, represents the decisions reached by your committee after careful deliberation over an extended period of time.

The provisions contained in your committee's bill can be summarized as follows:

(1) An investment credit against tax liability is provided. It generally is 8 percent of investments in new tangible personal property and certain other depreciable real property exclusive of buildings. A credit also is available, however, for limited amounts of used property which is purchased.

(2) A deduction is provided for costs relating to appearances before, and communications with a legislative body, legislative committee or individual legislator, if the expenses are otherwise ordinary and necessary business expenses. However, this does not include any advertising expenses or expenses concerned with political campaigns.

(3) Deductible expenses for entertainment, amusement, or recreation generally are limited to those directly related to the active conduct of a trade or business, and in the case of facilities also to those which are primarily used for the furtherance of the taxpayer's trade or business. Limitations are also provided in the case of business gifts. In addition, rules are set forth providing that deduction of these expenses will be denied unless they are substantiated.

(4) Distributions in kind from foreign corporations are treated as having a value equal to the fair market value of the property (and not the adjusted basis of this property in the hands of the distributing corporation where this is lower).

(5) Where goods are purchased or sold by a domestic corporation to a related foreign corporation, the income arising from these transactions is to be allocated between the parties on the basis of the location of the assets used in the operations, the payroll attributable to them and the related selling expenses. This rule will not be used where an arm's-length price can be established for the purchases or sales.

(6) The passive income of a foreign personal holding company is to be taxed to the U.S. shareholders if 20 percent or more of

its income is "foreign personal holding company income"; and if 80 percent or more of its income is of this type, then the remaining income of the company also is to be taxed to the shareholders.

(7) The present tax treatment of mutual savings banks, savings and loan associations, etc., is revised so that their additions to bad debt reserves generally may not exceed 60 percent of their taxable income (before this deduction) or, if larger, an amount bringing their reserves up to 3 percent of loans.

(8) Distributions by foreign trusts, established by U.S. grantors, are to be taxed to the U.S. beneficiaries in substantially the same manner as if they had received this income directly instead of through the intermediary of a foreign trust.

(9) Mutual fire and casualty insurance companies are to be taxed on their "total" income less a deduction for loss reserves equal to one-fourth of their underwriting gain plus 1 percent of their insurance claims. Most of this reserve is not actually used to offset losses, eventually will be subject to tax.

(10) Where a domestic corporation receives dividends from a foreign corporation, the amount included in its tax base if it elects the foreign tax credit is to be, not only the dividend itself, but also the tax paid by the foreign corporation as well.

(11) The unlimited exclusion from U.S. tax of income earned abroad by U.S. citizens who are bona fide foreign residents is reduced to $35,000 ($20,000 for the first 3 years). In addition, the contributions which employees make hereafter toward employee pensions based on foreign employment will be taxable to the employee when received.

(12) Shareholders of controlled foreign corporations are to report for tax purposes the undistributed earnings of these corporations to the extent they represent income from insuring U.S. risks, income from patents, copyrights, and exclusive formulas or processes developed in the United States, passive types of income generally, and income from certain sales. In these latter two cases reductions in the income tax to the shareholders are allowed for investments of the income in certain businesses in less developed countries. To the extent that the shareholders are not taxed on the income of the controlled foreign corporation under the above provisions, they are to be taxed on the undistributed earnings of controlled foreign corporations which are not invested in substantially the same trade or business or invested in less developed countries in new trades or businesses or in certain controlled subsidiaries.

(13) In the case of personal property and most real estate, other than buildings, when such property is sold at a gain this gain, to the extent of depreciation taken in prior years, is to be treated as ordinary income for tax purposes.

(14) When stock in foreign investment companies is sold, the gain realized by the U.S. shareholders is to be ordinary income to the extent of the earnings and profits accumulated since 1962. The companies and shareholders can avoid this treatment if the companies distribute 90 percent or more of their taxable income, other than capital gains, and the shareholders report the capital gains whether distributed or not.

(15) Where there is a redemption or liquidation of the stock of a controlled foreign corporation or where stock in such a corporation is sold, then any gain to the extent this gain represents earnings and profits of the corporation accumulated abroad is to be taxed to the principal shareholders as ordinary income or as dividends.

(16) Cooperatives are to receive a deduction for patronage dividends paid to their patrons in cash or by allocations if the patron has the option to redeem the notices of allocation in cash within a short period of time after they are issued, or consents to treat this income as constructively received and reinvested in the cooperative. The patron may give his consent individually in writing, or the cooperative may, through its bylaws, require all members (after notification) to give this consent. Where consent is given, or where the option to receive cash was available, the patron will be required to pay taxes on the patronage dividends if they arise from business activity.

(17) Real estate located outside of the United States, in the case of citizens or residents of the United States, is to be included in their tax base for purposes of the estate tax imposed at the time of death.

(18) Withholding is provided for dividends, most interest, and patronage refunds at a rate of 20 percent. No receipts are required under this system and exemption certificates and quick refunds provide for most cases where there otherwise would be overwithholding.

(19) Additional information is to be provided the Treasury Department by corporations and other businesses engaged in foreign operations.

II. REVENUE ESTIMATES

The revenue effect of your committee's bill is shown in tables 1 through 4 below. Tables 1 and 2 are based upon income levels for the calendar year 1962, but show the estimated revenue effect of the bill when all of the changes provided by it are fully effective. Table 1 does not take into account any effect the provisions of the bill may have on economic levels generally. Table 2, on the other hand, does take such effects into account but does not reflect any change in business attitude which may be brought about by the bill. Tables 3 and 4 estimate the effect of the bill on revenues in the fiscal year 1963, with table 3 not taking into account the effect of the provisions on economic conditions and table 4 taking such effect into account.

As indicated by table 1, the investment credit taken by itself is expected to result in an annual loss of revenue (when fully effective) of $1,800 million to $1,875 million. The other provisions of the bill are expected, when fully effective, to offset from $1,100 million to $1,295 million of this loss, leaving a net loss of from $505 million to $775 million. As indicated in table 2, the Treasury Department expects the stimulative effect of the investment credit to substantially reduce the net revenue loss of this provision, with the result that the revenue impact of the bill, over the long run, will be substantially in balance.

The revenue loss for the fiscal year 1963 is expected to be larger than in the long run. In large part this is due to the fact that the investment credit, which is the only provision resulting in a revenue loss, is effective as of the first of 1962, while most of the other provisions, which are the provisions providing the additional revenue, are not effective until the first of 1963. As a result, it is estimated that this bill will result in a revenue loss of from $1,425 million to $1,550 million in the fiscal year 1963, if no effect of the provisions on the economy is taken into account. The Treasury Department has estimated that if the effect of the provisions on the economy is taken into account, the revenue loss in the fiscal year 1963 will be reduced to $660 million.

TABLE 1.—*Estimated revenue effect of bill*[1] *when changes are fully effective, without taking into account the effect on the economy of the provisions*

[In millions of dollars]

	Estimates of staff of—	
	Joint Committee on Internal Revenue Taxation	Treasury Department
Revenue bill of 1962:		
Investment credit	−1,875	−1,800
Withholding on dividends and interest	+550	+650
Mutual banks and savings and loan associations	+160	+200
Entertainment expenses	+125	+125
Capital gains on depreciable property	+110	+100
Mutual fire and casualty companies	[2] +25	+40
Cooperatives	+30	+35
Foreign items:		
Controlled foreign corporation	+50	[3] +85
Gross-up of dividends	+25	+30
All other items relating to taxation of foreign income, etc	+25	+30
Total	−775	−505

[1] At levels of income and investment estimated for the calendar year 1962 except that the Treasury estimate of revenue gain from change in taxation of mutual banks and savings and loan associations is based on income levels for the calendar year 1963, the first year affected.

[2] Assumes transitional period has been completed for fire and casualty companies.

[3] The revenue estimates for the controlled foreign corporation provision do not take into account additions to the tax base, in the form of royalties, rents, etc., which reliable evidence indicates will be forthcoming but which cannot be quantified with an acceptable degree of accuracy.

TABLE 2.—*Treasury Department estimates of revenue effect of bill*[1] *when changes are fully effective and taking into account its estimate of effect on the economy of the provisions*

[In millions of dollars]

Revenue bill of 1962:	
Investment credit[2]	−900
Withholding on dividends and interest	+430
Mutual banks and savings and loan associations	+135
Entertainment expenses	+80
Capital gains on depreciable property	+50
Mutual fire and casualty companies	+25
Cooperatives	+25
Foreign items:	
Controlled foreign corporation[3]	+85
Gross-up of dividends	+30
All other items relating to taxation of foreign income, etc	+30
Total	−10

[1] At levels of income and investment estimated for the calendar year 1962 except that revenue gain from change in taxation of mutual banks and savings and loan associations is based on income levels for the calendar year 1963, the first year affected.

[2] In estimating the net revenue cost of the investment credit, its favorable effects on the level of investment were computed from statistical relationships in past years between investment and gradual changes in the cost of capital goods (profitability) and cash flow. This procedure thus does not take into account the especially favorable impact on businessmen's decisions to invest of the sudden major improvements in these factors resulting from the enactment of the credit. Taking this into account should produce more favorable effects and a smaller net revenue loss than the table shows.

[3] The revenue estimates for the controlled foreign corporation provision do not take into account additions to the tax base, in the form of royalties, rents, etc., which reliable evidence indicates will be forthcoming but which cannot be quantified with an acceptable degree of accuracy.

TABLE 3.—*Estimated revenue effect of bill for the fiscal year 1963, without taking into account the effect on the economy of the provisions*

[In millions of dollars]

	Estimates of staff of—		Effective date
	Joint Committee on Internal Revenue Taxation	Treasury Department	
Revenue bill of 1962:			
Investment credit	−1,800	−1,700	Jan. 1, 1962
Withholding on dividends and interest	+170	+205	Jan. 1, 1963
Mutual banks and savings and loan associations	+10		Do.
Entertainment expenses	+60	+65	July 1, 1962
Capital gains on depreciable property			Jan. 1, 1962
Mutual fire and casualty companies			Jan. 1, 1963
Cooperatives			Do.
Foreign items:			
Controlled foreign corporations			Do.
Gross-up of dividends			Do.
All other items relating to taxation of foreign income, etc	+10	+5	Do.
Total	−1,550	−1,425	

TABLE 4.—*Treasury Department estimates of effect of bill [1] for the fiscal year 1963 taking into account its estimate of effect on the economy of the provisions*

[In millions of dollars]

	Estimates of Treasury Department	Effective date
Revenue bill of 1962:		
Investment credit [1]	−900	Jan. 1, 1962
Withholding on dividends and interest	+195	Jan. 1, 1963
Mutual banks and savings and loan associations		Do.
Entertainment expenses	+40	July 1, 1962
Capital gains on depreciable property		Jan. 1, 1962
Mutual fire and casualty companies		Jan. 1, 1963
Cooperatives		Do.
Foreign items:		
Controlled foreign corporations		Do.
Gross-up of dividends		Do.
All other items relating to taxation of foreign income, etc	+5	Do.
Total	−660	

[1] In estimating the net revenue cost of the investment credit, its favorable effects on the level of investment were computed from statistical relationships in past years between investment and gradual changes in the cost of capital goods (profitability) and cash flow. This procedure thus does not take into account the especially favorable impact on businessmen's decisions to invest of the sudden major improvements in these factors resulting from the enactment of the credit. Taking this into account should produce more favorable effects and a smaller net revenue loss than the table shows.

III. INVESTMENT CREDIT

(Sec. 2 of the bill—new secs. 38 and 46–48 of the code)

A. *Reasons for provisions*

The President in his tax message to Congress last year urged the adoption of a tax incentive in the form of a credit against tax liability for certain types of investment. He renewed this request this year in both his budget message and his Economic Report.

In his Economic Report the President states—

> We must scrutinize our tax system carefully to insure that its provisions contribute to the broad goals of full employment, growth, and equity.

He indicates that his legislative proposals in the tax field are directly related to these goals and the corollary need for improvement in the balance of payments. He further states:

> The centerpiece of these proposals is the 8-percent tax credit against tax for gross investment in depreciable machinery and equipment. The credit should be retroactive to January 1, 1962. The tax credit increases the profitability of productive investment by reducing the net cost of acquiring new equipment. It will stimulate investment in capacity expansion and modernization, contribute to growth of our productivity and output, and increase the competitiveness of American exports in world markets.

The President also points out that the tax credit for investments is in part self-financing. He indicates that the stimulus it provides to new investments will have favorable effects on the level of economic activity during the year and that this will in turn add to Federal revenues.

The 8-percent tax credit provided by this bill is a complement to the administration's plans for revising the guidelines for the tax lives of property subject to depreciation. It is believed that the investment credit, coupled with the liberalized depreciation, will provide a strong and lasting stimulus to a high rate of economic growth and will provide an incentive to invest comparable to those available elsewhere in the rapidly growing industrial nations of the free world.

The Secretary of the Treasury has indicated that further depreciation revisions will be announced this spring. He has specified that the basic objective of these revisions is to provide realistic tax lives in the light of past actual practices and present and foreseeable technological innovations and other factors affecting obsolescence. The Secretary has stated that another facet of this objective is to achieve a more simple and flexible system of depreciation moving toward guideline lives for broad classes of assets used by each of the industries in our economy.

Realistic depreciation alone, however, is not enough to provide either the essential economic growth or to permit American industry to compete on an equal basis with the rapidly growing industrial nations of the free world. The major industrialized nations of the free world today provide not only liberal depreciation deductions but also initial allowances or incentive allowances to encourage investment and economic growth. This is true, for example, in Belgium, Canada, France, West Germany, Italy, Japan, the Netherlands, Sweden, and the United Kingdom.

The investment credit will stimulate investment because—as a direct offset against the tax otherwise payable—it will reduce the cost of acquiring depreciable assets. This reduced cost will stimulate additional investment since it increases the expected profit from their use. The investment credit will also encourage investment because it increases the funds available for investment. Generally, for each $100 of investment business, because of the tax credit, will have $8 more than otherwise would be the case for additional investment. Moreover, since the credit applies only to *newly acquired* assets, the incentive effect is concentrated on new investment and no revenue is lost in raising the profitability of assets already held by business firms. In addition, it is the hope of the committee that the savings from the credit itself also will be used for new investment in further advancing the economy.

The investment credit provided by this bill generally provides an offset against the tax otherwise due equal to 8 percent of the investments made. It does not affect the depreciation, which may be taken, either initially or in subsequent years. As a result the tax credit concentrates the benefit provided in the initial year of the investment, thereby maximizing the stimulative effect.

The investment credit in the case of most regulated public utilities is in effect 4 percent rather than 8 percent. The smaller credit is provided in such cases because much of its benefit in these regulated industries is likely to be passed on in lower rates to consumers, thereby negating much of the stimulative effect on investments. Moreover, the size of the investment in regulated public utilities, such as electric companies, local gas companies, telephone companies, etc., will in large part be determined by the growth of other industries, rather than their own.

In your committee's consideration of the investment credit last year it was planned to make the credit available only with respect to assets with a life of 6 years or over. However, its review this year has convinced your committee that the credit should be made available at least in part for shorter lived assets. There is a substantial volume of industrial equipment with lives of 4 and 5 years, investment in which should also be encouraged. At the same time your committee recognized that, with the more rapid turnover of short-lived assets, the plan as considered last year would have provided a substantially greater investment credit for short-lived assets than for longer lived assets. For example, in the case of a $1,000 investment in a 4-year asset, which is replaced as it wears out, three $80 credits could be obtained in the same time span in which one $80 credit could be obtained in the case of a $1,000 investment in a 12-year asset. As a result of these factors, your committee has provided that assets with lives of from 4 up to 6 years are to be taken into account in determining the allowable credit on the basis of one-third of the investment made; those with lives of from 6 up to 8 years are to be taken into account on the basis of two-thirds of the investment made; and only those with expected lives of 8 years and over will be taken into account on the basis of the full investment for purposes of the credit.

The bill, by limiting the credit principally to property which is new in use will limit the investment stimulant primarily to provision for new production facilities. However, because of the greater dependence of small business on used property, a limited credit is also made available for used property which is newly acquired.

The credit is available for investments in most tangible personal property. It also is available for limited types of real property, other than buildings. The greater emphasis is placed on equipment and machinery because it is believed the need for such investment is the major requirement of the economy.

B. General explanation of provision

1. Summary.—The bill provides a credit (in code sec. 38), which may be offset directly against income tax liability. The credit generally is an amount equal to 8 percent of "qualified investment" which includes both purchases of new equipment, and also, to a limited extent, purchases of used equipment. In the case of property with an expected useful life of 4 up to 8 years, the investment taken into account in computing the 8-percent credit is graduated from one-third in the case of the 4-year assets up to 100 percent in the case of property with a useful life of 8 years or more. In the case of most public utilities, however, only half of the investment as otherwise determined is included in computing the credit.

The types of property, whether new or used, which are included in qualified investment are described as "section 38 property." This property includes most tangible personal property. It also includes certain real property, other than buildings (or structural components) if the property is used directly in manufacturing, production, transportation, etc.

Once the amount of the 8-percent credit against tax is determined, the amount which may be claimed in any one year is limited to the tax liability, or if this tax liability exceeds $100,000, the credit (to the

extent it exceeds this amount) is limited to 50 percent of the tax liability. However, a 5-year carryforward is provided for any of these credits which because of this limitation are unused. The bill also provides that where the property is disposed of before the end of its life as estimated for the credit (and this is less than 8 years) the credit is reduced to the amount which would have been allowed initially had the useful life of the asset been correctly estimated.

These provisions are described briefly below.

2. Qualified investment.—Investment which is eligible for the 8-percent investment credit is referred to in the bill as "qualified investment" (sec. 46(c)). Qualified investment includes both new property and a limited amount of used property. Property qualifies for the investment credit in the year it is placed in service by the taxpayer, even though under the depreciation convention used by the taxpayer, he may not be eligible to start depreciation on the property until the coming year.

The percentage of investment which the taxpayer may take into account as qualified investment varies to some degree with the expected useful life of the property in his business. No part of the investment in property with an expected useful life of less than 4 years is taken into account. Property with an expected useful life of 4 years and up to (but not including) 6 years is taken into account at one-third of the amount of the investment actually made; property with an expected useful life of 6 years and up to (but not including) 8 years is taken into account on the basis of two-thirds of the investment made; and property with a longer life is taken into account at the full amount of the investment.

Public utility property is taken into account as qualified investment at one-half of the amount otherwise allowable. Thus, in the case of 4- or 5-year public utility property, one-sixth of the investment is taken into account; in the case of 6- or 7-year property, one-third of the investment is taken into account; in the case of property with a life of 8 years or more, one-half is taken into account. This means that in the case of public utility property with an expected useful life of 8 years or more, in effect a 4-percent credit is allowed. Public utility property for this purpose means property used predominantly in an electrical energy, water or sewage disposal business, a local gas distribution business, a telephone business, or a domestic telegraph business, but only if the rates involved in all of these cases are subject to regulation by a governmental agency or commission.

3. New and used property.—The new property taken into account as qualified investment (sec. 48(b)), must be purchased or otherwise acquired after December 31, 1961, and its first use commenced by the taxpayer after that date. Other new property eligible for the credit also includes property constructed, reconstructed, or erected by the taxpayer after that date. These are the same rules which applied with respect to the new forms of depreciation provided in 1954.

Used property (sec. 48(c)), eligible for the credit, also must be purchased after December 31, 1961, but, of course, is not property which is new in use with the taxpayer. To prevent abuse, however, there has been omitted from the term "used property," available for the credit that which is used by a person who used the property before such acquisition (and also that which is so used by a person who

is related to a person who used the property before its present acquisition).

The cost of any used property which may be taken into account is limited to $50,000 a year. Where used property with varying useful lives is acquired the taxpayer may select the property to be taken into account for the investment credit. Presumably he will select assets with lives of 8 years or more since there is no one-third or two-thirds reduction in such cases.

In the case of a husband and wife filing separate returns, the amount of used property which may be taken into account by each is $25,000 instead of $50,000, unless one of the two has not purchased any used section 38 property, in which case the other spouse may claim the entire amount up to $50,000. This prevents any double allowance for married couples. In the case of affiliated groups of corporations (with a 50-percent test of common ownership instead of the 80 percent usually applied), there is to be one $50,000 used property allowance for the group and it is to be apportioned among the members of the group in accordance with their purchases of this property. In the case of partnerships, this limitation applies both at the partnership level and also with respect to each partner. Thus, $50,000 is the limit with respect to used property which may be qualified for any partnership, and then there is a further $50,000 limit at the partner level. This latter limit may further restrict the used property eligible for the credit where a partner, in addition to his share of investment in one partnership, has either from another partnership or as a sole proprietor, additional used property investment for which he may receive a credit. The total of these which qualify for the credit may not exceed $50,000.

To prevent a double allowance where used property is traded in on used property, or where used property is disposed of and other used property "similar or related in service or use" is acquired as a replacement, the cost otherwise allowable for the used property acquired is reduced by the adjusted basis of the property disposed of in both of these types of cases. However, this "replacement" reduction in the credit is not to apply where there otherwise is a reduction in the credit for the property disposed of because of its disposal within 8 years and before the end of what had been its estimated useful life. (See heading 5 below.)

4. "Section 38" property.—Section 38 property (defined in sec. 48(a)), is the only property (either new or used) which is treated as "qualified investment." Except for the exclusions noted below, all tangible personal property qualifies as section 38 property. Except for buildings and their structural components, real property which is used as an integral part of manufacturing, production or extraction or of furnishing transportation, communications, electrical energy, gas, water or sewage disposal services also qualifies as section 38 property. This is also true of real property (other than buildings and structural components) used for research or storage facilities with respect to any of the above categories. Tangible personal property is not intended to be defined narrowly here, nor to necessarily follow the rules of State law. It is intended that assets accessory to a business such as grocery store counters, printing presses, individual air-conditioning units, etc., even though fixtures under local law, are

to qualify for the credit. Similarly, assets of a mechanical nature, even though located outside a building, such as gasoline pumps, are to qualify for the credit. Real property (other than buildings and structural components) which qualifies as integral parts of categories referred to above includes such assets as blast furnaces, oil and gas pipelines, railroad track and signals, and fences used in connection with raising cattle.

Section 38 property must be depreciable property and have a useful life of 4 years or more. As indicated elsewhere, property with estimated useful lives of from 4 to 8 years is only partially taken into account for purposes of the investment credit.

There also are certain categories of property which are excluded from the definition of section 38 property and, therefore, cannot qualify for the credit. These exclusions are:

(1) Property used predominantly to furnish lodging or in connection with the furnishing of lodging. However, there are two exceptions to this exclusion. First, property used in nonlodging commercial facilities (such as a restaurant) located in lodging facilities (such as a hotel) may qualify for the credit if the nonlodging commercial facilities are available for use by the general public on the same basis as for the lodgers. Second, property used in a hotel or motel which primarily serves transient guests may qualify for the credit. The first of these two rules is essential to place nonlodging commercial facilities located in an apartment building, etc., on an equal competitive basis with similar facilities located elsewhere. The allowance of the credit in the case of a hotel or motel also is used in a regular commercial venture and, therefore, it was believed that it too should be eligible for the investment credit.

(2) Property used by a tax-exempt organization (other than in a business to which the unrelated business income tax applies). The limitation on the allowance of the credit in this case is designed to prevent an investment for use in connection with an exempt function from decreasing any tax on an unrelated trade or business.

(3) Property used by governmental units. Property leased to governmental units is omitted since allowing the lessor in such cases an investment credit would not be expected to increase the use of such property by the governmental units.

(4) Property used predominantly outside of the United States. However, there are certain exceptions where this type of property is eligible for the credit, namely, in the case of domestically owned aircraft, rolling stock of railroads, vessels and motor vehicles, where the use is partially within and partially without the United States. Similarly, an exception is made for domestically owned containers which are used in the transportation of property to or from the United States. A further exception is made for domestically owned property used in exploring for, developing, removing, or transporting natural resources from the Outer Continental Shelf of the United States. Property used predominantly outside of the United States (with the exceptions noted) is omitted, since the primary purpose of the credit is to encourage investment within the United States.

5. *Limitation on tax credit.*—The tax credit, under your committee's bill (sec. 46(a)(2)) may not exceed the tax liability, or if the tax liability is in excess of $100,000, may not exceed $100,000 plus 50 percent of the tax liability over this amount. This limitation, while leaving substantial leeway for utilizing the credit, is designed to prevent it (in combination with other tax credits) from relieving the taxpayer from any substantial tax contribution. However, in recognition of the problems of small business, the bill does not impose this limitation with respect to the first $100,000 of any tax liability.

Although this limitation with respect to the allowance of the investment credit is imposed for the year in which the investment is made, nevertheless, any investment credit which, because of this limitation, cannot be used in the current year may be carried forward by the taxpayer and used in any of the succeeding 5 years if the credit in any such year is less than the tax limitation.

Tax liability for purposes of this limitation is computed without regard to the accumulated earnings tax or personal holding company tax liability, but after the application of the foreign tax credit, the 4-percent dividends-received credit, the credit for partially tax-exempt interest and the retirement income credit. In order to prevent a full allowance with respect to $200,000 of tax liability in the case of a married couple, the bill provides that for a married individual filing a separate return the tax liability limitation is $50,000 instead of $100,000. However, if either the husband or the wife has no qualified investment (or unused credit carryover), the one having the investment or carryover may make use of the entire $100,000. In the case of an affiliated group there is one $100,000 of tax liability which can be fully offset by qualified investment and this is by regulations to be apportioned among the members of the affiliated group.

6. *Certain dispositions of section 38 property.*—To guard against a quick turnover of assets by those seeking multiple credit,—the bill provides (in sec. 47) a special adjustment. Under this provision if property is disposed of, or otherwise ceases to be section 38 property, the tax for the current year is to be increased by the reductions in investment credits (which would have resulted in the prior years) had the investment credits allowable been determined on the basis of the *actual* useful life of the property rather than its *estimated* useful life. This means, for example, that if an asset which had previously been estimated to have a useful life in the business of 8 years or more actually is used by the taxpayer only for 6 years, the investment credit for the year in which the investment was originally made will be recomputed on the basis of two-thirds the investment made. Had this asset been sold after 4 or 5 years' use, the allowable investment would have been recomputed on the basis of one-third of the actual investment and had it been sold after a still shorter period, no credit at all would have been allowed.

Although the credit is recomputed for the earlier year in which the investment was made, the actual adjustment in tax occurs in the current year, namely, the year in which the asset is disposed of (or otherwise ceases to be sec. 38 property). This makes it unnecessary actually to recompute taxes in the prior years, or to extend the statutory periods of limitations. An adjustment is also made in any carryovers of unused credits so that they too will reflect the reduced amount of investment to be taken into account.

Although disposal of assets within a shorter period of time than their estimated useful life (where this is less than 8 years) usually will be the factor resulting in downward adjustments in the credit allowed, the credit must also be adjusted if property ceases to qualify as section 38 property; where, for example, its use becomes predominantly outside of the United States. A downward adjustment in the credit also is required where property is converted to public utility property for which only a reduced credit is available. As indicated previously, a credit is allowed for certain types of public utility property equal only to half of the credit generally allowable. Where property is converted to such use (again, before the end of its estimated useful life and within the 8-year period) a downward adjustment must be made. In this case, however, instead of disqualify-one-third, two-thirds, or all of the property, depending upon the period of time involved before the conversion to public utility use is made, one-half of such an adjustment is made, since the public utility property itself qualifies for the credit for the remaining period of time but on a reduced basis.

Few exceptions are made to the adjustment rule for the credit described above because in no case does this result in a lesser credit than would be available had the useful life of the property been estimated accurately. Moreover, since the tax increase occurs in the current year, and not with respect to the prior year in which the investment occurred, no interest is charged with respect to the increase in tax resulting from the reduction in credit. As a result, your committee believed that it was necessary to forego the application of the adjustment rule only in the case of the transfer of property by reason of the death of the taxpayer or in the case of corporations where a successor corporation "stands in the shoes" of the predecessor corporation. The successor corporation in such a case, of course, must continue to hold the property for the appropriate period of time, or an increase will be made in its tax because of the disposition of the property prior to the end of its estimated useful iife.

7. *Election for leased property.*—The bill provides (in sec. 48(d)) that a person engaged in the business of leasing property may elect with respect to new property to treat the investment as if made by the lessee instead of the lessor. This election applies only with respect to new property and is not available for used property. Permitting the investment credit to be passed on to the lessee in these cases is believed to be desirable since, as a result of this provision, it is possible for the lessor to pass the benefit of the investment credit on to the party actually generating the demand for the investment.

If the lessor makes this election, then the lessee is treated for purposes of this provision as if he had acquired the property himself, that is, generally he will be treated as if he had acquired the property for the lessor's cost or other basis for the property. However, if the lessor constructed the property (or a corporation controlled by or which controlled the lessor did so) the lessee is treated as having acquired the property for its fair market value. The useful life of the property in the hands of the lessee in such cases is to be its useful life in the hands of the lessor for purposes of computing the size of the credit available. This is true whether or not the lease itself is for a shorter period of time. Of course, in such cases if the lessee does not renew the lease and hold the property for the estimated useful

life of the property in the hands of the lessor, then a downward adjustment will be made in his investment credit.

8. Special classes of taxpayers.—A number of special categories of taxpayers receive special tax treatment under the Internal Revenue Code which makes it inappropriate in their cases to allow the full investment credit. For other taxpayers, the code provides that income may be taxed in part to the organization and in part to its shareholders or beneficiaries. In these situations your committee's bill either cuts down the allowance of the tax credit in proportion to the special benefit received, or provides for the apportioning of the investment credit between the organization and its shareholders or beneficiaries in accordance with their sharing of income for tax purposes. Similar adjustments are also provided in the $100,000 tax liability limitation.

In the case of mutual savings banks, building and loan associations and cooperative banks, the investment credit allowable is reduced by 50 percent (largely offsetting the 60 special deductions they are allowed). The $100,000 tax liability limitation is also similarly reduced for these organizations.

In the case of regulated investment companies and real estate investment trusts, the qualified investment allowed them and the applicable $100,000 tax liability limitation are reduced in the same proportion in which their taxable income is reduced by dividends paid to shareholders or beneficiaries. Similarly, in the case of cooperatives, the qualified investment and $100,000 tax liability limitation to be taken into account are reduced in the same proportion in which their taxable income is reduced for patronage dividends (and in the case of exempt cooperatives its deductions for dividend payments on capital stock, patronage distributions with respect to U.S. business and income distributed to patrons from sources other than patronage).

In the case of subchapter S corporations, i.e., corporations treated in a manner similar to that of partnerships, since it is the shareholders, rather than the corporation, who are taxed on the income of the corporation, the bill (sec. 48(e)) divides the qualified investment for each year on a pro rata basis among the shareholders of the corporation at the end of the year. In this case since the shareholders are treated as the taxpayer, the investment maintains its character as new or used section 38 property in their hands. Similarly, the bill (in sec. 48(f)) provides that qualified investment in the case of estates or trusts is to be apportioned between the estate or trust on one hand and the beneficiaries on the other on the basis of the income of the estate or trust allocable to each. As in the case of the subchapter S corporations, the beneficiary is treated as the taxpayer with respect to the investment apportioned to him and therefore the investment retains its character in his hands as new or used section 38 property. The $100,000 tax liability limitation in the case of the estate or trust is reduced in proportion to the total income allocated to other than the estate or trust.

9. Carryovers in the case of certain corporate acquisitions.—Generally, in the case of certain tax-free acquisitions of assets of one corporation by another, present law provides that certain items of the first corporation are to be carried over and attributed to the second. This includes such items as net operating loss carryovers, earnings and

profits, methods of accounting, methods of computing depreciation allowance, etc. The bill adds to this list (sec. 381(c)(23)) a carryover to the acquiring corporation in the case of these tax-free reorganizations of the status of the prior corporation with respect to items required to be taken into account for purposes of the investment credit. This mainly is concerned with (1) the carryover of the possibility of adjustment with respect to the investment credit where an asset is held for less than the full period of its estimated useful life and (2) the carryover of any unused investment credit in the prior 5 years.

10. Effective date.—The bill provides that the investment credit is to apply to taxable years ending after December 31, 1961. However, in the definition of new section 38 property and also used section 38 property (the only types of property eligible for the credit) it is provided that a credit is to be available only with respect to acquisitions after December 31, 1961, or in the case of new property only with respect to the portion of the property which is constructed, reconstructed or erected after that date. The combination of the effective date and these definitions of new and used section 38 property in effect provide that the investment credit is to be available only with respect to property acquired (or in the case of new property also constructed, reconstructed, or erected) after December 31, 1961, with respect to taxable years ending after that date.

IV. APPEARANCES, ETC., WITH RESPECT TO LEGISLATION

(Sec. 3 of the bill—sec. 162(e) of the code)

A. Reasons for provision

Present law allows deductions for income tax purposes for ordinary and necessary expenses paid or incurred in carrying on a trade or business. No mention, however, is made in the statute of expenses incurred in making appearances, submitting material, or communicating with respect to legislative matters. However, Treasury regulations in effect prior to the enactment of the 1954 Code disallowed deductions for expenditures for such purposes (regulations 118, secs. 39.23(o)–1(f) and 39.23(q)–1(a)).

In 1959, the Supreme Court handed down two companion decisions upholding the validity of these regulations, *Cammarano* v. *U.S.* and *F. Straus & Sons, Inc.* v. *U.S.* (358 U.S. 498 (1959)). The Court held that although the amounts expended for legislative matters were "ordinary and necessary"—in fact essential to the very survival of the taxpayer's business—nevertheless they were not deductible because the regulations barred the deduction of this particular type of expense. The court recognized that the statute contained no provisions specifically supporting the regulations, but stated that they had acquired the force of law by reason of congressional reenactment of the underlying statute.

Following the *Cammarano* decision, the Treasury Department promulgated new regulations relating to deductions incurred with respect to legislative matters. These regulations, while following the general rules set forth in the earlier regulations for the first time stated specifically that several different classes of expenditures are to be disallowed as deductions. For example, the new regulations require

the disallowance of a deduction for the portion of dues and other payments to any organization, a "substantial part" of the activities of which consist of lobbying to the extent that such amounts are "attributable to" these activities. Similarly, the regulations now state that expenditures for the promotion or defeat of legislation include expenditures for the purpose of attempting to influence members of a legislative body directly or indirectly, by urging or encouraging the public to contact the members.

The regulations issued by the Treasury Department in 1959 brought to a head many administrative and enforcement problems and uncertainties which have plagued both the Government and taxpayers. The difficulty in allowing trade or business expenses generally, but isolating expenses relating to legislative matters and denying deductions for them, stems in part from the difficulty in segregating and classifying such expenses. This is a form of detailed recordkeeping to which taxpayers are not accustomed. Moreover, in the case of many expenses which may primarily be incurred to inform the business itself as to the application of certain proposed legislation, when such information is also made available to legislators it is difficult to determine how an allocation of the expense should be made between legislation and mere planning of the company. Moreover, in the case of an organization, a determination must also be made as to whether the expenses of this type are substantial—a term which involves a difficult determination.

More important than the administrative and enforcement problems, however, are the policy considerations involved in denying expenses with respect to legislative matters. It appears anomalous, for example, that expenses incurred in appearing before legislative bodies or before legislators are not deductible while appearances before executive or administrative officials with respect to administrative matters, or before the courts with respect to judicial matters, are deductible where the expenses otherwise qualify as trade or business expenses. Your committee believes that the present bar on deductions with respect to legislative matters must be modified to place presentations to the legislative branch of government on substantially the same footing in this respect as that with the other two coordinate branches of government.

It also is desirable that taxpayers who have information bearing on the impact of present laws, or proposed legislation, on their trades or businesses not be discouraged in making this information available to the Members of Congress or legislators at other levels of government. The presentation of such information to the legislators is necessary to a proper evaluation on their part of the impact of present or proposed legislation. The deduction of such expenditures on the part of business also is necessary to arrive at a true reflection of their real income for tax purposes. In many cases making sure that legislators are aware of the effect of proposed legislation may be essential to the very existence of a business. The deduction of legislative expenses for those who incur them for personal reasons is not proposed here, since such expenses are not deductible with respect to administrative or judicial presentations and have no bearing on the determination of true taxable income of a business.

B. General explanation of provision

The bill adds a new subsection (sec. 162(e)) to the provision of present law relating to the deduction of trade or business expenses. It provides that certain types of expenses incurred with respect to legislative matters are to be deductible if in all other respects they qualify as trade or business expenses.

The expenses which may be deducted are divided into two categories. The first category relates to expenses in direct connection with appearances, submission of statements or sending of communications. These appearances, statements or communications may be presented either to committees or individual Members of Congress or to committees or individual members of State or local governmental legislatures. The second category of expenses which may be deducted are those in direct connection with the communication of information between the taxpayer and an organization of which he is a member. This communication of information may be either from the organization to the taxpayer or vice versa. In the case of both categories of expenses referred to above, in order for the expense item to be deductible, it must be concerned with legislation or proposed legislation of direct interest to the taxpayer (and to the organization in the latter case). Thus, the expenses may not be in connection with legislative matters such as nominations, etc., but rather must be in connection with specific legislation or proposals for legislation.

The bill also provides that where a taxpayer is a member of an organization and the organization pays or incurs the expenses of the types referred to above on behalf of its members, the dues which the taxpayer pays to the organization in carrying on his trade or business are to be deductible to the extent they are used for such purposes. The remainder of the dues is likely already to be deductible as ordinary and necessary business expenses. Of course, the dues to an organization may be deductible although not all of the organization's legislative activity is connected with each specific member's trade or business. It is sufficient if all of the organization's legislative activity is related to the trade or business of a significant number of the members.

The bill provides two limitations on the deduction of the above-specified expenses for the specified types of legislative activity. It is not intended by your committee that any deduction be allowed for an amount paid or incurred for participation or intervention in any political campaign for any candidate. Of course, this includes participation or intervention in political campaigns in opposition to a candidate as well. Your committee's bill further provides that no expense deduction is to be allowed for expenditures to influence the general public, or segments thereof, with respect to legislative matters, elections, or referendums. Thus, no deduction is intended to be allowed for expenses incurred in connection with what is usually called "grassroot" campaigns intended to develop a point of view among the public generally which in turn is directed toward the legislators.

Nothing in this provision is intended to permit the deduction of entertainment expenses. Such amounts, if deductible at all, must meet the tests set forth in the section of the bill explained below, without regard to this provision.

This provision is to be effective with respect to taxable years beginning after December 31, 1962.

V. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES

(Sec. 4 of the bill and sec. 274 of the code)

A. Reasons for provision

The Treasury brought to your committee's attention widespread abuses have developed through the use of the expense account. In his tax message to the Congress last year, the President stated his conviction that entertainment and related expenses, even though having an association with the needs of business, confer substantial tax-free personal benefits on the recipients; and that in many instances deductions are obtained by disguising personal expenses as business expenses. He recommended that the cost of such business entertainment and the maintenance of entertainment facilities be disallowed in full as a tax deduction, and that restrictions be imposed on the deductibility of business gifts and travel expenses.

After full hearings on the proposal and careful consideration of the problem, your committee has concluded that additional restrictions should be imposed on deductions for entertainment and traveling expenses and business gifts. The committee agrees that abuses in this or any other area of the tax law should not be tolerated, but it does not believe that complete disallowance of such expenses, as recommended by the President, is the proper solution to the problem.

Your committee's bill is designed to eliminate the abuses which have developed in this area. The bill provides new rules which, in general, would: (1) disallow a deduction with respect to entertainment activities, except to the extent that the expense is directly related to the active conduct of a trade or business; (2) disallow a deduction with respect to entertainment facilities, unless the facility is used primarily for the furtherance of the taxpayer's trade or business and the expense is directly related to the active conduct of the trade or business; (3) abolish the Cohan rule by requiring the taxpayer to substantiate, by adequate records or by sufficient evidence corroborating his own statement, all expenditures for entertainment and related facilities, and for travel and gifts; and (4) limit the deduction for gifts to $25 per year per recipient.

The amendments made by this section are to apply to taxable years ending after June 30, 1962, but only with respect to expenditures incurred after that date.

B. General explanation of provision

Your committee's bill adds a new provision to the code (sec. 274), which disallows, in whole, or in part, certain expenses which would be fully deductible under present law. The requirements imposed by this bill are in addition to the requirements for deductibility imposed by other provisions of existing law, which must be met by the taxpayer before this new provision becomes operative. Hence, if an expenditure is claimed under section 162, the taxpayer must first establish that it constitutes an ordinary and necessary expense incurred in carrying on a trade or business, before the provisions of section 274 become applicable.

The only purpose of this section is to disallow deductions in certain cases and therefore this bill does not affect the question of the includi-

bility or excludibility of an item in income of any individual. The rules presently applicable under present law will continue to govern in this respect. Thus, for example, while pins or watches presented to an employee upon his retirement will not be regarded as gifts under this provision, this bill will have no effect in determining whether the recipient of the pin or watch will be taxed on their value.

1. Disallowance of expenses for entertainment activities.—The first part of the bill provides that no deduction is to be allowed for any expense with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, except to the extent that the taxpayer establishes that the expense was directly related to the active conduct of his trade or business. Certain exceptions to this rule are provided, however, for expenses not required to meet the new tests. They are discussed in No. 5 below.

Entertaining guests at night clubs, country clubs, theaters, football games, and prizefights, and on hunting, fishing, vacation and similar trips are examples of activities that constitute "entertainment, amusement, and recreation." In addition, "entertainment" includes any business expense incurred in satisfying the personal, living, or family needs of any individual, such as the furnishing of food and beverages. a hotel suite, or an automobile. An objective test will be employed in determining whether an activity is of a type generally considered to constitute entertainment, amusement, or recreation, but the particular business of the taxpayer will be considered in applying this objective test. For example, with respect to a taxpayer who is a professional hunter, a hunting trip would not generally be considered a recreation-type activity. On the other hand, with respect to a taxpayer whose trade or business consists of selling machine tools or manufacturing clothing, a hunting trip generally would be considered a recreation-type activity. Similarly, a theatrical performance would generally be considered an entertainment-type activity, but in the case of a professional theater critic, a theatrical performance would not constitute an entertainment activity.

An objective standard also will overrule arguments such as the one which prevailed in *Sanitary Farms Dairy, Inc.* (25TC 463 (1955)) that a particular item was incurred, not for entertainment, but for advertising purposes. If the activity typically is considered to be entertainment, amusement, or recreation, it will be so treated under this provision. This will be so even where the expense relates to the taxpayer alone.

With respect to expenses for entertainment activities, the bill provides that a deduction will be allowed only to the extent that the taxpayer establishes that the expense was directly related to the active conduct of his trade or business. This means that the taxpayer must show a greater degree of proximate relation between the expenditure and his trade or business than is required under present law. Among other things he will have to show more than a general expectation of deriving some income at some indefinite future time from the making of the entertainment-type expenditure; however, he will not be required to show that income actually resulted from each and every expenditure for which a deduction is claimed.

If the expenditure is for entertainment which occurs under circumstances where there is little or no possibility of conducting business affairs or carrying on negotiations or discussions relating thereto, the

expenditure will generally be considered not to have been directly related to the active conduct of business. Thus, the absence of the taxpayer or his representative from the entertainment activity ordinarily indicates that the entertainment was not directly related to the conduct of the taxpayer's trade or business. Similarly, if the group of persons entertained is large or the distractions substantial, the cost of the entertainment will not be deductible, in the absence of a clear showing of a direct relationship to the active conduct of the trade or business. All the facts and circumstances pertaining to the entertainment activity will be considered in this connection. Thus, expenses incurred for a "hospitality room," at a convention, at which good will is promoted through display or discussion of the taxpayer's products will be treated as so directly related.

Under the bill, deductions for expenditures with respect to entertainment-type activities are limited to the portion of such expense which is directly related to the active conduct of the taxpayer's trade or business; expenses not directly related to the active conduct of business are not deductible. Objective standards will be employed to determine the apportionment between the part of the expense which meets this test and the part which does not. Thus, if a taxpayer entertains a group of 10 individuals, 3 of whom are business customers (with respect to whom this relationship can be established) and 7 of whom are guests (with respect to whom this relationship cannot be established), a deduction will be allowed only for the expenses attributable to the 3 business customers. Since the subjective intent of the taxpayer is not relevant to this determination, it would make no difference that the taxpayer in the above example would not have had the party but for the attendance of the 3 business customers.

Expenses for entertainment, amusement, and recreation should be identified by the taxpayer on his return and treated under the new rules of this bill. It ordinarily will not be appropriate to include these expense items in other categories of business deductions, where their character will not be apparent, such as advertising, public relations, cost of goods sold, reimbursed expenses, etc.

2. Disallowance of expenses for entertainment facilities.—Your committee's bill (sec. 274(a)) also limits the deduction for expenditures incurred with respect to facilities used for entertaining. Under the bill, no deduction is to be allowed with respect to expenses relating to facilities unless the taxpayer establishes (1) that the facility was used primarily for the furtherance of his trade or business and (2) that the expenditure was directly related to the active conduct of his trade or business. In no event can the deduction exceed the portion of the expense which is directly related to the active conduct of the taxpayer's trade or business. Certain exceptions to this rule are provided, however, for expenses not required to meet the new tests. They are discussed in No. 5 below.

The term "facility" includes any item of personal or real property owned or rented by the taxpayer, such as a yacht, hunting lodge, fishing camp, swimming pool, tennis court, bowling alley, automobile, airplane, apartment, hotel suite, home in vacation resort, dining room, and cafeteria. In addition to items commonly regarded as expenses "with respect to a facility," such as expenditures for the maintenance, preservation, or protection of the facility, this provision

also relates to depreciation and losses realized on certain sales of entertainment facilities.

Under the bill, if a facility is used more than one-half for business entertaining, so that more than one-half of the entertainment expense with respect to such facility would be deductible as a business expense under present law, that portion would continue to be deductible to the extent it meets the test of being directly related to the active conduct of the taxpayer's trade or business. If less than one-half of such entertainment expense would be deductible under present law, no deduction would be allowed. Under this provision the facility must actually be used in furtherance of the taxpayer's trade or business; it is not sufficient that the facility is merely "available" for business use. In connection with these determinations, objective rather than subjective standards would be employed.

This rule will prevent tax abuses involving luxury facilities for entertainment, amusement, or recreational purposes. Under this rule a taxpayer who lives in a luxurious apartment and who presently deducts a portion of its rent on the ground that the apartment was used for occasional entertaining of business guests (and thus had a business purpose), no longer will be able to deduct any portion of the rent because the principal purpose of the apartment is personal, rather than business. Moreover, a swimming pool constructed at the taxpayer's residence may not be charged off for tax purposes as an ordinary and necessary business expense unless the taxpayer demonstrates that personal, family, or living purposes were not primarily served by use of the pool.

Club dues and fees paid to any social, athletic or sporting club or organization are treated by the bill as an expense with respect to a facility used for entertainment and therefore will not be deductible where the primary use of the club facilities is personal. If membership entitles the member's entire family to use the facilities of the club, their use will be considered in determining whether business use of the club exceeds personal use. Where the primary use of the club facilities is in furtherance of a trade or business the cost of the club dues or fees will be deductible to the extent of the use directly related to the active conduct of business. Thus, if membership in a club costs \$100 per year and the club is used for such direct business purposes three-fourths of the time, \$75 will be deductible. As in the case of other facilities, it is the actual use of the club which establishes the deductibility of the club dues, not its availability for use, and not the taxpayer's principal purpose for joining the club. However, this does not mean that out of pocket business entertainment expenses incurred at a club will not be deductible where the required direct relationship between the entertainment and the taxpayer's trade or business is shown to exist. Such expenses will be deductible without regard to the tax treatment of club dues.

Club dues for this purpose do not include dues or fees paid for membership in such civic organizations as Kiwanis, Lion's Club, Rotary, Civitan, and similar groups because these organizations are not social, athletic or sporting clubs. Similarly, professional associations such as bar associations and medical associations are not considered social, athletic or sporting clubs. Deductibility of these dues will continue to be governed by the rules of existing law.

3. Business gifts.—Under your committee's bill, deduction for business gifts will be disallowed to the extent that the total gifts during the year exceed $25 with respect to any person. Where gifts are made to the wife of a man who has a business contact with the donor, these gifts are considered as made indirectly by the husband (for purposes of the limitation).

There is the possibility of overlapping application of the entertainment expense and gift provisions in this new section. An item which might be held to be a gift might also be held to be an entertainment expense. For example, tickets to a theater might fall in either category. Since different rules will apply depending upon the category in which the expense item falls, specific regulatory authority is given to the Secretary of the Treasury or his delegate to prescribe, in cases where both provisions would otherwise apply, which provision is to govern. Thus, a "gift" of theater tickets probably would be classified as coming under the entertainment provision, while a book probably would be classified as coming under the gift provision.

4. Disallowance of expenditures not substantiated.—Under the bill, taxpayers will be required to substantiate their entertainment and related expenses, their traveling expenses and gift expenses. The bill provides that the taxpayer must substantiate by adequate records or by other sufficient evidence corroborating his own statement the amount of such expense or other item; the time and place of the travel, entertainment, amusement, recreation, or use of the facility, or the date and description of the gift; the business purpose of the expense; and the business relationship to the taxpayer of the person entertained, using the facility, or receiving the gift.

This provision is intended to overrule, with respect to such expenses the so-called *Cohan* rule. In the case of *Cohan* v. *Commissioner*, 39 F. 2d 540 (C.A. 2d, 1930), it was held that where the evidence indicated that a taxpayer had incurred deductible expenses but their exact amount could not be determined, the court must make "as close an approximation as it can" rather than disallow the deduction entirely. Under your committee's bill, the entertainment, etc., expenses in such a case would be disallowed entirely.

The requirement that the taxpayer's statements be corroborated will insure that no deduction is allowed solely on the basis of his own unsupported, self-serving testimony. However, the degree of corroboration required to support a claimed deduction will vary as respects the business relationship and purpose, the time and place, and the amount of the expense. Thus, oral testimony of the taxpayer, together with circumstantial evidence available, may be considered "sufficient evidence" for the purpose of establishing the business purpose required under the new provision. However, oral testimony of the taxpayer plus more specific evidence would be required to be "sufficient evidence" as to the amount of an expense.

Generally, the substantiation requirements of the bill contemplate more detailed recordkeeping than is common today in business expense diaries. However, a clear, contemporaneously kept diary or account book containing information with respect to the date, amount, nature and business purpose of the expense may constitute an adequate record under this provision.

Your committee does not intend by this substantiation requirement to deny a taxpayer deductions for entertainment, etc., expenses where

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he has no records if it can be shown that the failure to produce substantiating records was due to circumstances beyond his control, such as destruction of his records by fire or flood. In such a case, the taxpayer will be permitted to reconstruct the business entertainment, travel, or gift expenses incurred by him in the taxable year.

Under the bill, the Secretary or his delegate may, by regulation, prescribe certain situations in which the substantiation requirements will not be applied. For example, it may be provided that substantiation will not be required for traveling expenses, where such expenses (including the cost of meals and lodging) do not exceed prescribed minimum amounts. This will be of special benefit to employees whose per diem allowance while traveling is within limits established by the Secretary under this provision. Thus, if regulations are issued under which substantiation will not be required for traveling or entertainment expenses where per diem allowances do not exceed 125 percent of per diem allowed a Government employee in the same locality, it would be sufficient evidence for purposes of the substantiation rule to establish only the amount of the allowance and the fact that the business travel occurred.

5. *Exceptions where disallowance provisions will not apply.*—The bill contains nine exceptions to the general disallowance provision described above under heading 1 or 2. Where an expense falls within one of the enumerated exceptions, the item will continue to be deductible to the same extent as allowed by existing law. However, the new substantiation requirements (discussed under heading 4) will have to be satisfied with respect to any such expense. The exceptions are as follows:

(*a*) Expenses for food and beverages furnished under circumstances which are of a type generally considered to be conducive to a business discussion. The question as to whether the circumstances are conducive to a business discussion are to be tested by such standards as: First, the surroundings in which the meal or beverage was furnished; second, the taxpayer's trade or business or income-producing activity; and third, the relationship to such trade, business, or activity of the persons to whom the food and beverages were furnished.

(*b*) Expenses for food and beverages (and facilities used in connection with them) furnished on the business premises of the taxpayer primarily for his employees. This is intended to exclude from the disallowance provision facilities such as the company cafeteria or an executives' dining room. This exception would continue to apply even though guests are occasionally served in the cafeteria or dining room.

(*c*) Goods, services and facilities to the extent that the entertainment, amusement, or recreation (or use of the facility) is treated on the taxpayer's return with respect to the recipient of the entertainment as compensation paid to an employee and from which income tax is withheld. For example, if the taxpayer permitted an employee to use a yacht for a vacation and treated the expenses for its use as compensation paid to the employee for purposes of the withholding tax and for purposes of the taxpayer's tax return, maintenance and crew costs attributable to such use would be deductible in full because of this exception. On the other hand, where a yacht was used exclusively for business enter-

taining the salaries paid to the captain and crew, even though they were treated as compensation and withheld on, would not come within this exception because they are not the recipients of the entertainment.

(*d*) Expenses paid or incurred by the taxpayer where he pays or incurs the expenses for his employer or a client, customer, etc., and where he is reimbursed by the employer or client, etc. This is designed to prevent the double disallowance of a single expenditure, once to the employee or practitioner, etc., and a second time to the employer or client, etc. This provision will not apply, however, in the case of an employee where the employer treats the amount paid to him as compensation. It also will not apply in the case of a practitioner, etc., unless he accounts to the client, etc., for the expenses incurred. The accounting must represent sufficient substantiation to meet the tests set out under heading No. 4. Thus, if a lawyer enters into a fee arrangement under which his client agrees to reimburse him for expenses (including entertainment expenses) the exception will not apply unless he accounts to his client sufficiently to enable the client to substantiate the expenses as required by the bill.

(*e*) Expenses incurred for recreation, social, or similar activities (including facilities) primarily for the benefit of employees. The employees referred to in this case are those, other than officers, shareholders, or highly compensated employees. In this case an individual would be considered a shareholder only if he (taking into account holdings of members of his family) holds an interest in the corporation of 10 percent or more. This category is intended to pertain to the usual employee fringe benefit programs, such as expenses of operating a company swimming pool or baseball diamond, as well as the expenses of the annual company picnic or Christmas office party.

(*f*) Expenses directly related to business meetings of employees or stockholders. While this category will apply to business meetings where some social activities are provided, it is not intended to apply to gatherings which are primarily for social purposes rather than for the transaction of the employer's or company's business.

(*g*) Expenses directly related and necessary to attendance at a business meeting of any organization, such as a trade association, chamber of commerce, real-estate board, etc., described in section 501(c)(6) of the code.

(*h*) Expenses for goods, services, and facilities made available to the general public by the taxpayer. This pertains to expenses for the entertainment of the general public by means of television, radio, newspapers, and the like. It also permits deductions for expenses for parks, etc., maintained by companies where the general public may attend. Expenses of distributing samples to the general public would also come within this exception.

(*i*) Expenses for goods or services (including the use of facilities) which are sold by the taxpayer in a bona fide transaction for an adequate and full consideration in money or money's worth. This exception is designed to insure that a taxpayer who sells entertainment to others will be allowed to deduct expenses of producing that entertainment. Thus salaries paid to employees

of nightclubs and amounts paid to performers other than employees will continue to be deductible by the operator. Moreover, since this type of expense is not considered to be "entertainment" the detailed substantiation requirements prescribed in this bill will not apply.

6. *Interest, taxes, casualty losses.*—The restrictions provided by your committee's bill are not to apply with respect to items which are deductible under specific provisions of law which apply both to business and nonbusiness taxpayers. Thus, deduction for interest paid on a loan to acquire an entertainment facility or property taxes paid with respect to it would continue to be allowed as a deduction, whether or not the entertainment facilities meet the tests of the new provision.

7. *Treatment of entertainment-type facilities.*—Under the bill, if deductions with respect to entertainment-type facilities are disallowed, the disallowed portion is to be treated as an asset which is used for personal, living, and family purposes, rather than as an asset used in the trade or business. Under this provision the basis of such an entertainment-type facility will be adjusted for purposes of computing depreciation deductions and determining gain or loss on the sale of such facility in the same manner as other property (for example, a residence) which is regarded as used partly for business and partly for personal purposes. Thus, if a taxpayer has a yacht which is used three-fourths for direct business entertainment purposes, and he ordinarily would be entitled to $1,000 for depreciation with respect to the yacht (if it were used entirely for business), $250 of this amount would be disallowed as a depreciation deduction and would be treated as the basis of an asset not used in the taxpayer's business.

8. *Meals and lodging while in travel status.*—The bill also amends section 162(a)(2) of present law which provides that traveling expenses include "the entire amount expended for meals and lodging." Your committee's bill provides that traveling expenses shall include "a reasonable allowance for amounts expended for meals and lodging." This has been the position taken in Treasury regulations for many years.

9. *Effective date.*—The amendments made by this provision are to apply with respect to taxable years ending after June 30, 1962, but only in respect of periods after that date.

VI. DISTRIBUTIONS IN KIND BY FOREIGN CORPORATIONS

(Sec. 5 of the bill and sec. 301 of the code)

A. Reasons for provision

Under present law, when a distribution in kind is made by a corporation to a shareholder which is also a corporation, the amount which is treated as a distribution is the fair market value of the property received or, if lower, the adjusted basis of the property in the hands of the distributing corporation. Where both the distributing corporation and its corporate shareholder are domestic corporations, taking into account the adjusted basis when it is lower than the fair market value of the property may be justified on the grounds that the appreciated property is still owned by a corporation and, in fact, very little has happened. Furthermore, if the distributee corporation sells the property, the same amount of gain will be realized and taxed as if the

distributor corporation had sold it. Where the distributing corporation is a foreign corporation, however, the device of distributing to its U.S. corporate shareholder appreciated property can be used as a device to permit the U.S. corporation to realize on the earnings and profits of the foreign corporation at minimum U.S. tax. Assume, for example, that an American parent has a 100-percent owned foreign subsidiary. This foreign subsidiary has $100,000 in accumulated earnings and profits resulting from foreign earnings all of which enjoyed complete deferral from U.S. tax. Assume further that the foreign subsidiary is in a position to distribute to its American parent either $50,000 in cash or a valuable piece of property having a fair market value of $50,000 but an adjusted basis of only $20,000. Under existing law, the dividend income to the American parent is $50,000 if the cash is distributed but is only $20,000 if the property is distributed. Under the amendment proposed by the bill, however, the dividend income to the parent is the same amount ($50,000) whether the cash or the property is distributed. This result is believed appropriate since the increase in value of the parent's assets is the same whether it receives the cash or the property.

This is a companion provision to section 16 of this bill. These two provisions taken together are designed to give assurance that when funds are withdrawn from foreign corporations by liquidation of the corporation, sale of the stock or distribution of property in kind that a full U.S. tax is obtained.

B. General explanation of provision

This provision amends existing law (sec. 301(b)(1)(C)) to provide that where there is a distribution in kind from a foreign corporation and the shareholder is a corporation, then the amount of the distribution for dividend purposes is to be the fair market value of the property distributed, and not its adjusted basis in the hands of the distributor where this is lower.

An exception to the rule described above is provided where the distributing corporation, although a foreign corporation, during the 3 years ending with the close of the corporation's taxable year, derived more than 50 percent of its income from sources within the United States. In such cases, to the extent that the income is subject to U.S. tax, the corporation receiving the dividend can continue to apply the rule generally available for domestic corporations. Thus, to the extent the dividend is treated as eligible for the 85-percent dividends received deduction, the amount of distribution will be the adjusted basis of the property to the distributing corporation where this is lower than its fair market value.

The bill also makes appropriate basis adjustments to take into account the changed rules with respect to dividend distributions.

The amendments made by this provision are to apply to distributions made after December 31, 1962.

VII. ALLOCATION OF INCOME BETWEEN RELATED FOREIGN AND DOMESTIC ORGANIZATIONS

(Sec. 6 of the bill and sec. 482 (b) of the code)

A. Reasons for provision

Under present law, foreign corporations which are controlled by domestic corporations or other persons are not taxed by the United States on their foreign source income. Thus, United States imposes no tax with respect to the profits of such a corporation when they are earned although it does impose a tax on the domestic shareholders of this corporation when they receive dividend distributions from it. This taxation at the time of distribution, rather than at the time the income is earned by the foreign corporation, has become known as "tax deferral." U.S. corporations, it is believed may sell goods to their controlled foreign subsidiaries at less than a fair price to avoid a U.S. tax on what should be their full profit for such sales. Similarly, in other cases it is believed that foreign-controlled subsidiaries have sold goods to their domestic parent at more than the fair market price. The effect of such transactions is to understate the taxable income of the domestic corporation subject to U.S. tax and to overstate the income of the foreign subsidiary. Thus, to the extent the U.S. tax rate is above that imposed by the foreign country or country involved, tax deferral is achieved with respect to this diverted income during the period of time the income is held abroad. The Secretary of the Treasury, in his testimony last year on this subject stated:

> This is not simply a question of allocating the profits of foreign operations to tax haven countries. It is a problem that significantly affects U.S. taxation of domestic profits. The technique that is used for diverting profits from one company to another among European affiliates is also used to divert income from U.S. companies to foreign affiliates. Income that would normally be taxable by the United States is thrown into tax haven companies with the object of obtaining tax deferral. This is done, for example, by placing in a Swiss or Panamanian corporation the activities of the export division of a U.S. manufacturing enterprise. A very substantial volume of exports is required merely to offset the loss in foreign exchange which the retention abroad of export profits entails.

Present law in section 482 authorizes the Secretary of the Treasury to allocate income between related organizations where he determines this allocation is necessary "in order to prevent evasion of taxes or clearly to reflect the income of any such organizations." This provision appears to give the Secretary the necessary authority to allocate income between a domestic parent and its foreign subsidiary. However, in practice the difficulties in determining a fair price under this provision severely limit the usefulness of this power especially where there are thousands of different transactions engaged in between a domestic company and its foreign subsidiary.

Because of the difficulty in using the present section 482, your committee has added a subsection to this provision authorizing the Secretary of the Treasury or his delegate to allocate income in the

case of sales or purchases between a U.S. corporation and its controlled foreign subsidiary on the basis of the proportion of the assets, compensation of the officers and employees, and advertising, selling and sales promotion expenses attributable to the United States and attributable to the foreign country or countries involved. This will enable the Secretary to make an allocation of the *taxable income* of the group involved (to the extent it is attributable to the sales in question) whereas in the past under the existing section 482 he has attempted only to determine the fair market sales price of the goods in question and build up from this to the taxable income—a process much more difficult and requiring more detailed computations than the allocation rule permitted by this bill.

The bill provides, however, that the allocation referred to will not be used where a fair market price for the product can be determined. It also provides that other factors besides those named can be taken into account. In addition, it provides that entirely different allocation rules may be used where this can be worked out to mutual agreement of the Treasury Department and the taxpayer.

B. General explanation of provision

The bill adds a new subsection (b) to the provision of existing law (sec. 482) authorizing an allocation of income between corporations (or other persons) controlled directly or indirectly by the same interests. The new subsection applies only to sales of tangible property within a group where one of the organizations is domestic and another is foreign (however, there may be more than one domestic or more than one foreign organization involved) but only where the organizations are owned or controlled directly or indirectly by the same interests. In such cases the Secretary of the Treasury or his delegate is authorized (but not required) to allocate the income of the group arising from these sales under the allocation rule described below. Nevertheless, this allocation rule is not to apply where the taxpayer can establish an arm's-length price for the goods in question.

Under the general allocation rule provided by the bill the Secretary or his delegate is to allocate the income between the United States organization and the foreign organization on the basis of the proportion of the assets, the compensation of officers and employees and the advertising, selling and sales promotion expenses of the group which on one hand are not attributable to the United States and which on the other hand are attributable to the United States. For this purpose, only those assets, that compensation and those sales, etc., expenses which are attributable to the property so sold or purchased are to be taken into account.

The allocation need not be based upon the above-mentioned factors alone. The provision specifically authorizes the inclusion of other factors such as special risks, if any, of the market in which the product is sold. In addition, if the taxpayer or the Secretary or his delegate can work out some other mutually agreeable method of allocating income, this alternative method is to be used instead of the rule referred to above.

Generally, the value of the assets to be taken into account in the allocation method is to be the adjusted basis of these assets in the hands of the taxpayer. However, in the case of some foreign corporations, a U.S. concept of adjusted basis for assets may be difficult,

if not impossible, to compute. In such cases, their book values may be used, adjusted to the extent feasible to approximate adjusted basis. The assets to be included in this allocation formula are real property and tangible personal property except inventory and stock in trade. In addition, real property and tangible personal property which are rented are to be taken into account for this purpose.

As indicated previously, the allocation method described above is not to apply to any sale where the taxpayer can establish an arm's-length price. An arm's-length price for this purpose can be established under either of two procedures. First, the taxpayer can determine the arms-length price by establishing the price at which similar or comparable property is sold in the same general marketing areas to unrelated persons either by the taxpayer or by third parties, if the conditions of sale are similar. Second, if the taxpayer cannot determine such a price, nevertheless he may still establish an arm's-length price by taking the price at which similar or comparable property is sold in either the same or other market areas where the marketing conditions or quantities sold may be different. In such cases such a price can be used, but only after adjustment is made for the material differences in area, quantity, or in marketing conditions (including custom duties and transportation costs) and in any other relevant factors. Moreover, these adjustments must be determinable.

The bill provides that the Secretary or his delegate is by regulations to set forth procedures which are similar in principle to those specified above which are to be applied where one of the organizations in the group receives a sales commission, rather than actually receiving title to goods and then selling them. The bill also provides in the case of "sham" or "paper" corporations that no amount is to be allocated to a foreign corporation under this formula if its assets, personnel and office and other facilities outside of the United States are grossly inadequate to provide for its activities outside of the United States.

The bill also provides that the Secretary or his delegate may require the taxpayer to furnish information which may be "reasonably supplied" to the extent this information is needed to apply the allocation rule referred to above which makes use of assets, compensation and selling expenses. Failure to supply this information can lead to the Secretary or his delegate allocating all of the income to the United States.

The bill also provides that where, under the allocation rule set forth in this provision, income is allocated to the domestic corporation which had been subject to foreign income taxes in the hands of the foreign corporation, these foreign taxes, like other expenses related to the income reallocation, are to be attributed to the domestic corporation. Thus, if the domestic corporation is claiming a foreign tax credit, rather than taking a deduction for foreign taxes, a foreign tax credit will be available with respect to this transferred tax as well. However, the income so reallocated for purposes of the overall or per country limit is not to be classified as foreign income.

This provision is to apply with respect to taxable years beginning after December 31, 1962.

VIII. DISTRIBUTIONS OF FOREIGN PERSONAL HOLDING COMPANIES

(Sec. 7 of the bill and secs. 552 and 556 of the code)

A. Reasons for provision

Under present law certain foreign corporations are classified as "foreign personal holding companies" and their income is taxed, on a pro rata basis, to their American shareholders. For a company to be so classified more than 50 percent of its stock must be owned, directly or indirectly, by five or fewer U.S. citizens or residents. In addition, 60 percent, or 50 percent in certain cases, of its gross income must be foreign personal holding company income, that is, must be "passive" types of income, such as dividends, interest, royalties, rents in certain cases, etc.

Elsewhere in this bill (sec. 13) your committee has attributed to U.S. shareholders the passive income of foreign corporations under a much lower income test than the 60 or 50 percent presently applicable to these foreign personal holding companies. In this latter case, where the principal shareholders are likely to be corporations, if from 20 to 80 percent of the gross income of the company is from the specified types of passive income, then the U.S. shareholders are taxed upon their share of this income, or if this passive income exceeds 80 percent of the company's gross income, then the shareholders are taxed on the entire income of the corporation.

In view of the stricter income tests to be made applicable in this latter case, your committee concluded that the foreign personal holding company provisions of present law should be modified to conform.

B. General explanation of provisions

This section makes two modifications in the present foreign personal holding company tax. First, it provides that a company is to be classified as a foreign personal holding company if 20 percent of its gross income is personal holding company income, that is, passive income from dividends, interest, royalties, rents in certain cases, etc. Under present law a corporation initially becomes subject to personal holding company tax only when 60 percent or more of its gross income is derived from the specified types of income. However, once classified as a foreign personal holding company it will remain so if 50 percent or more of its income is derived from these types of income. The 50-percent test will continue to be applied thereafter until there is a year in which the corporation does not have the 50-percent stock-ownership referred to above, or until an elapse of 3 years in which less than 50 percent of its income is from the specified sources. Under the bill the single 20-percent test, applied annually, is to replace this provision.

The second change made in the present foreign personal holding company provisions relates to the definition of "undistributed foreign personal holding company income," namely; the income which on a pro rata basis is attributed to the shareholders. Under present law the undistributed foreign personal holding company income is the entire taxable income with certain modifications (for taxes, charitable contributions, net operating loss deductions, etc.) minus the dividends

paid during the year (and consent dividends). Under your committee's bill this definition of undistributed foreign personal holding company will remain the same in those cases where the specified types of passive income exceed 80 percent of the company's gross income. However, if the foreign personal holding company's passive income represents from 20 to 80 percent of its gross income, then the income to be attributed to the shareholders as undistributed foreign personal holding company income is to be the same proportion of its taxable income (with present law modifications) minus dividends paid (and consent dividends) as its foreign personal holding company income is of its gross income.

These changes are effective with respect to taxable years of the foreign corporations beginning after December 31, 1962.

IX. MUTUAL SAVINGS BANKS, ETC.

(Sec. 8 of bill and secs. 593, 595 and 7701(a) of code)

A. Reasons for provision

Until 1952 mutual savings banks, domestic building and loan associations and certain cooperative banks (hereinafter referred to as mutual savings institutions) were exempt from Federal income tax. This exemption had initially been based upon the premise that the members' money in the case of these institutions was being used for loans to members, or that the institutions were in effect doing business with themselves and that since the earnings of the institutions belonged to the depositors rather than to it, there could be no profit on which to impose an income tax.

In 1951, however, Congress repealed the exemption of these mutual savings institutions and subjected them to the regular corporate income tax. At the same time, however, these institutions were allowed a special deduction for additions to bad-debt reserves which proved to be so large that they have remained virtually tax exempt since 1951. The 1951 legislation provided that additions could be made to a reserve for bad debts in whatever amount the institution deemed appropriate so long as (1) the amount set aside each year did not exceed the income returned by the institution for the year, or (2) its total reserves and surplus did not exceed 12 percent of its deposits or withdrawable accounts at the close of the year.

The President in his tax message of April 20, 1961, observed that—

> Some of the most important types of private savings and lending institutions in the country are accorded tax deductible reserve provisions which substantially reduce or eliminate their Federal tax liability.

He further stated that—

> These provisions should be reviewed with the aim of insuring nondiscriminatory treatment.

Subsequently, the Treasury Department in its report of July 1, 1961, stated that—

> This special bad-debt reserve provision has kept these institutions virtually tax exempt because they may accumulate $12 tax free for each $100 of new deposits. During

> 1960, these institutions had assets of about $110 billion and they retained on a tax-deductible basis, current earnings of over $750 million. For 1958, * * * these institutions paid total Federal income taxes of $8.8 million.

Your committee has reviewed the tax treatment of the mutual savings institutions. It has concluded that the present bad-debt reserve provisions are unduly generous and that they require revision. Accordingly, your committee's bill amends the special bad-debt reserve provisions of existing law which are applicable to these institutions to provide what it believes will be an assurance that significant tax will be paid in most cases on the retained earnings of these institutions. The bill provides reserves consistent with the proper protection of the institution and its policyholders in the light of the peculiar risks of long-term lending on residential real estate which is the principal function of these institutions.

Under the bill, mutual savings institutions will be permitted to add to reserves for bad debts each year whichever of the following amounts is the greatest:

(1) 60 percent of taxable income [1] for the year computed before a bad-debt deduction,

(2) an amount sufficient to bring the balance of the reserve for losses on qualifying real property loans to 3 percent of such loans outstanding at the close of the taxable year, plus an amount sufficient to bring the balance of the reserve for losses on other loans to a reasonable amount, or

(3) if an institution demonstrates a need for a reserve greater than is permissible under (1) or (2), an amount sufficient to bring the overall balance of its reserves to a "reasonable" amount.

Most of these institutions can be expected to use the 60-percent alternative in making additions to their bad-debt reserves. Those who use this method of necessity will be paying tax if they have any taxable income before this deduction. The 3-percent alternative will be primarily beneficial to new or rapidly expanding institutions. These additions to bad-debt reserves provided by the bill should be sufficient to enable these mutual savings institutions to provide adequate returns to depositors and at the same time continue to provide a steady supply of capital to homebuyers of the Nation.

The bill also provides rules governing the tax treatment of mortgage foreclosures by mutual savings institutions. Other important changes include the establishment of a priority for distributions to stockholders in the case of stock savings and loan associations and a change in the definition of "domestic building and loan association." Your committee's bill also repeals the exemptions provided federally chartered savings and loan institutions in the case of the excise taxes on communications and on the transportation of persons.

B. General explanation of provision

1. Additions to reserves for losses on loans.—In the case of mutual savings institutions the bill provides new rules for calculating the deduction allowable for additions to bad-debt reserves, or reserves for losses on loans as they are referred to in the bill. Beginning in 1963, these institutions will maintain two accounts to which additions will

[1] For this purpose, taxable income does not include certain amounts required to be charged to reserves by stock companies.

be made in the future with respect to reserves for bad debts.[2] One of the two accounts is a reserve for "losses on qualifying real property loans," the additions to which can be determined by the taxpayer under rules set forth in the bill. The other is a reserve for "losses on nonqualifying loans."

Additions to this latter account are required to be "reasonable additions" which means that as in the case of other taxpayers these additions to these reserves will be determined upon the basis of the past experience and other appropriate factors.

In the case of the reserve for losses on qualifying real property loans, the addition to be made each year to this reserve is to be determined by the taxpayer but may not exceed whichever of the following is the largest:

(*a*) 60 percent of the institution's taxable income for the year computed before this deduction.

(*b*) the amount necessary to increase the balance in the reserve for losses on qualifying real property loans to 3 percent of such loans outstanding at the close of the taxable year plus a reasonable addition to the reserve for losses on nonqualifying loans;

(*c*) if the institution demonstrates the need for greater reserves than are permitted under (*a*) or (*b*) above, an amount which would be permitted to be added to a reserve for bad debts without regard to the special provision for mutual savings institutions.

Your committee's bill does not impose any overall ceiling on the amount which may be accumulated by a mutual savings institution with respect to its reserve for losses on qualifying real property loans. However, your committee intends from time to time to review the status of this reserve to be sure that the balances maintained in these reserves remain reasonable in light of the overall requirements of the mutual savings institutions.

When losses on loans are realized they will be charged to the appropriate account within the general reserve for bad debts. That is, losses on loans with respect to qualifying real property will be charged to the reserve for such loans and losses on nonqualifying loans will be charged to the reserve for losses on such loans.[3]

The reserves which are required by the bill to be established—that is, the reserve for losses on qualifying real property loans, the reserve for losses on nonqualifying loans, and the supplemental reserve for losses on loans—are required to be treated as bad debt reserves for all tax purposes (except that no deduction is allowed for any addition to the supplemental reserve). Thus, although these reserves are termed reserves for "loans," they are reserves for bad debts; and any charge to any such reserve for an item other than a bad debt will result in the inclusion in gross income of an amount equal to such charge.

For purposes of determining annual additions to the reserve for losses on qualifying real property loans, mutual savings institutions are to take into account all loans secured by improved real property (whether such loans are insured or uninsured) except Government bonds, certain corporate obligations and certain loans between banks

[2] They may also have a supplemental reserve which will represent certain reserves built up in the period from 1952 through 1962. This supplemental reserve is explained below.

[3] At the election of the taxpayer, losses on any loan instead of being charged to the reserve referred to above may be charged in whole or in part to the supplemental reserve for losses on loans referred to below.

and related parties. Under this provision, both federally insured FHA and guaranteed VA home loans, as well as conventional loans, may be taken into account in determining the amount of additions to the reserve for losses on qualifying real property loans. Loans on improved real property are intended for this purpose to include loans obtained for the construction of improvements on real property, even though at the time the loan is made no improvements may exist on the property.

The following examples illustrate the operation of the alternative choices for additions to reserves for bad debts:

Example 1: At the close of year 10, X building association has improved real property loans outstanding of $2,000 and nonqualified loans of $200. Its taxable income before any addition to a reserve for bad debts is $50. The balance in its reserve for losses on improved real property loans is $51 and the balance in its reserve for losses on nonqualifying loans is $1. (Its experience indicates the need for a reserve for losses on nonqualifying loans of 1 percent of such loans, and a reserve for losses on improved real property loans of 2.5 percent of such loans.)

For this year X building association would be permitted to add to its reserves $30 (60 percent times $50). (Under the 3-percent method only $10 could have been added.) Of this amount $1 would be added to the reserve for losses on nonqualifying loans (making the balance in that account $2) and $29 would be added to the reserve for losses on improved real property loans (making the balance in that account $80). Taxable income for this year would then be $20.

Example 2: Assume the same facts, except that taxable income before any addition to reserve for bad debts is $15. X building association would be permitted to add to its reserves $10. This is the amount necessary to bring the balance of the reserve for losses on nonqualifying loans to $2 (1 percent times $200) plus the amount necessary to bring the balance of the reserve for losses on improved real property loans to $60 (3 percent times $2,000). (Under the 60-percent method the addition would have been only $9.) Taxable income would then be $5 ($15 minus $10).

2. Treatment of pre-1963 reserves.—At the present time bad-debt reserves etc. of mutual savings banks are about 10 percent of their deposits, while similar reserves of domestic building and loan associations average about 8 percent of deposits. This means that existing reserves of these mutual savings institutions in most cases will exceed 3 percent of improved real property loans, plus a reasonable reserve for other loans.

The bill makes special provision for the treatment of existing bad-debt reserves of mutual savings institutions. If the entire amount of such reserves (called "pre-1963 reserves" in the bill) were required to be allocated to the reserve for losses on qualifying real property loans and to the reserve for losses on nonqualifying loans, the balances of those reserves would in many cases be so large that many mutual savings institutions would be denied a deduction for additions to bad-debt reserves for many years. In order to mitigate this effect, your committee's bill provides that only a portion of such pre-1963 reserves is to be allocated to the reserve for losses on qualifying real

property loans and to the reserve for losses on nonqualifying loans under the following rules:

(*a*) First there is credited to the reserve for nonqualifying loans whatever portion of these pre-1963 reserves is necessary to bring the balance of this reserve to an amount which would be reasonable on the basis of nonqualifying loans outstanding as of December 31, 1962;

(*b*) next there is credited to the reserve for losses on qualifying real property loans whatever remaining portion of the pre-1963 reserves is necessary to bring the balance of this reserve up to 3 percent of loans on improved real property outstanding as of December 31, 1962, or to a greater amount if the experience of the institution as of December 31, 1962, indicates a need for a greater reserve; and

(*c*) finally, any remaining pre-1963 reserves are credited to the supplemental reserve for losses on loans.

Amounts credited to the supplemental reserve for losses on loans can be used only to offset losses on loans (if the institution chooses to charge losses to this reserve). Any other use of this reserve will result in the imposition of income tax.

3. Distributions to shareholders.—Some of the savings and loan associations to which this provision is applicable have shares of stock outstanding. Your committee desires to insure that in such cases no amounts are paid to these stockholders until full income tax had been paid with respect to the profits which are distributed to such stockholders; and that the earned surplus which is accumulated under the reserve provisions of the bill should be for the protection of depositors. Therefore, the bill provides that in the case of distributions to the stockholders, the amounts are to be considered as paid out of the following funds of the institution:

(*a*) first out of the reserve for losses on qualifying real property loans (but only to the extent the balance in such reserve exceeds the amount which would have been allowed the institution in the absence of this special bad-debt provision);

(*b*) next out of the supplemental reserve for losses on loans;

(*c*) then out of earnings and profits accumulated in taxable years beginning after December 31, 1951; and

(*d*) finally, out of other amounts.

Before distributions can be made out of either the reserve for losses on qualifying real property loans or out of the supplemental reserve, income tax must be paid with respect to the amount required to be charged by the stock institution. The amount required to be charged to these reserves and included in income is the amount of the distribution to the stockholder "grossed-up" by the appropriate amount of tax. Only after these reserves (modified as indicated) are exhausted, can distributions be made out of amounts which have already been tax paid. These special rules will insure that the current profit which is allocated to stockholders will pay a regular corporate income tax.

4. Foreclosures on property securing loans.—Your committee's bill also adds a new provision to the code containing rules to govern the tax consequences of mortgage foreclosures (or other similar proceedings) in which mutual savings institutions take over property which was security for its loan. Under existing law the foreclosure event is considered a taxable transaction. This has been interpreted to mean

that a bad-debt (or loss) deduction may or may not arise at that time depending upon the bid price for the property. In many instances foreclosed property is bid in for the amount of the loan still outstanding. In such a case present law may not permit a bad-debt deduction to be taken. When the property is subsequently sold by the mutual savings institution, it may simultaneously realize a deductible bad-debt loss and a taxable capital gain.

The bill seeks to avoid these erratic results by providing that in the future a foreclosure is not to be treated as a taxable event, and that amounts received by the mutual savings institution subsequent to the foreclosure are to be treated as payments on the indebtedness. This would be accomplished under the bill by treating the property received in a foreclosure (or other proceeding) as having the same characteristics as the debt for which it was security. Thus, for bad-debt (or loss) purposes the act of foreclosure will not create a taxable occasion; however, if the property has depreciated in value, the decline may be charged against the bad debt reserve as a partially worthless debt. If it continues to decline in value, additional charges may be made against the reserve. When the property is subsequently sold or disposed of, any amount realized is to be treated as ordinary income or loss and is to be charged, or credited, as the case may be, against the primary reserve. Because the foreclosed property is to have the same characteristics as the indebtedness, where property is rented by the mutual thrift institution after foreclosure, no depreciation deduction is to be permitted. However, as explained above, if the property actually depreciates in worth (as contrasted to a mere decline in book value), a charge may be made against the reserves.

5. *Definition of domestic building and loan association.*—Under present law a domestic building and loan association is defined as a—

> domestic building and loan association, a domestic savings and loan association, and a Federal savings and loan association, substantially all of the business of which is confined to making loans to members.

Problems have arisen with this definition because loans in many cases now are in substance not loans made to members. It is understood that technical conformance has been maintained with the membership requirement of present law by making borrowers of funds members of the institutions. However, questions have arisen as to the substance of such provisions.

As a result, your committee has concluded that the definition of a domestic building and loan association, eligible for the tax treatment described above, should be brought more nearly into conformance with actual practice. At the same time it was deemed desirable to restrict this tax treatment to those primarily engaged in making residential real estate loans and omitting from the definition cases such as those where these institutions have been used for speculative purposes.

In view of these considerations, your committee has redefined a domestic building and loan association to mean a building or savings and loan association which is an insured institution within the meaning of section 401(a) of the National Housing Act or one which is subject by law to supervision and examination by State or Federal authority having supervision over such associations. In addition, however,

the bill provides that an institution in either of these groups qualifies only if substantially all of its business consists of accepting savings and investing the proceeds in—

(*a*) loans secured by an interest in residential real property (or property which after application of the loan is to become such property), and

(*b*) other loans to the extent they would be authorized to be made by a Federal savings and loan association under the second paragraph of section 5(c) of the Home Owners' Loan Act.

The types of loans referred to in the second paragraph of section 5(c) of the Home Owners' Loan Act include home-improvement loans whether or not secured by real property.

6. *Repeal of certain excise tax exemptions.*—Under present law, Federal savings and loan associations are exempt from the excise taxes on communications and the excise tax on transportation of persons. These exemptions were granted by the Home Owners' Loan Act of 1933. No other mutual savings institution is entitled to exemption from these taxes. Your committee believes that the continuation of these exemptions is no longer desirable. Accordingly, the bill repeals these exemptions effective as of June 30, 1962.

7. *Effective date.*—The new rules provided by the bill for additions to reserves for bad debts are to apply to taxable years ending after December 31, 1962. However, the bill provides a special rule to deal with fiscal years where a taxpayer has a year which begins in 1962 and ends in 1963. The effect of this special rule is to continue the rules under existing law up to the end of December 1962, and to apply the new rules as of January 1, 1963.

The tax treatment provided for property acquired in mortgage foreclosure proceedings is to apply to transactions occurring after December 31, 1962, in taxable years ending after that date. The repeal of the exemptions from excise taxes on communications and on transportation of persons is made effective as of June 30, 1962.

X. DISTRIBUTIONS BY FOREIGN TRUSTS

(Sec. 9 of bill and secs. 643, 665, 666, 668, 669, 6047, 6677 and 7701 of code)

A. Reasons for provision

The Secretary of the Treasury in his appearance last year before your committee called attention to the manner in which some individuals establishing foreign accumulation trusts are avoiding U.S. tax. The avoidance device involves the setting up of a trust for the benefit of U.S. beneficiaries by a U.S. grantor or settlor in a foreign country where such trusts are subject to little or no taxation. U.S. tax on the trust income is avoided in such cases if the trust property consists of foreign securities which result in foreign source income not subject to taxation by the United States. The trust income is then accumulated tax-free in the trust (except for foreign tax, if any) for any number of years, and then the trust is finally terminated with the corpus and income being paid to U.S. citizens or residents. In such cases the trust income may be subject to a small tax or no tax at all in the hands of the U.S. beneficiaries, depending upon the circumstances.

Under present law, domestic trusts accumulating income are taxable on such income currently at the same rates applicable to individuals. When the accumulated income is distributed to beneficiaries, the distribution may then be taxable to the beneficiaries to the extent it represents income accumulated during the 5 immediately preceding years. Although the tax is payable currently in such cases, it is computed as if the beneficiary received a distribution of this income in each of these prior years in which the income was earned, with a credit being allowed for the taxes paid by the trust with respect to this income.

This rule, known as the "5-year throwback rule" presently may apply when a foreign trust makes distributions to U.S. beneficiaries. In any case, however, it does not apply to any income accumulated for more than 5 years. In addition, there are a number of exceptions making distributions nontaxable to the beneficiaries even where they are attributable to the 5 immediately preceding years. For example, the 5-year throwback rule does not apply to accumulations to be distributed to a beneficiary upon reaching age 21; to a beneficiary to meet emergency needs; to a beneficiary upon reaching a specified age if not more than four such distributions can be made or the distributions are at least 4 years apart; and to a beneficiary where a trust terminates and makes a final distribution which occurs more than 9 years after the date of the last transfer to the trust. As a result of these exceptions, and the 5-year limitation, it is relatively easy for U.S. grantors or settlors to establish foreign trusts which pay little or no tax on trust income and which upon termination make distributions to American beneficiaries who pay little or no U.S. tax.

In the last Congress, a bill (H.R. 9662) which was passed by the House, but on which action was not completed by the Senate, contained an amendment added by the Senate Finance Committee designed to discourage the creation of foreign trusts for the purpose of avoiding U.S. tax. In addition, the Secretary of the Treasury in his testimony before your committee last year recommended that with respect to existing trusts the law be modified so that distributions to a U.S. beneficiary from a foreign trust would be subject to tax in the year of distribution in an amount equal to the tax which would have been imposed had the income been distributed currently. As indicated by the Secretary in his testimony, this is in effect an extension of the existing 5-year throwback rule.

In view of the existing avoidance possibilities with respect to these foreign trusts, your committee's bill, as recommended by the Secretary of the Treasury, taxes American beneficiaries of foreign trusts created by U.S. grantors, settlors or transferrors in substantially the same manner as if the income had been distributed to the beneficiary currently as earned (although a "shortcut" method of computation may be elected by the taxpayer in place of this more "exact" method). This provision is not viewed by your committee as imposing a penalty but rather as a method for treating U.S. beneficiaries of foreign accumulation trusts created by, or added to, by Americans in substantially the same tax status as the beneficiaries of domestic trusts distributing their income currently.

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B. General explanation of provision

The new provision applies to foreign trusts to which money or property has been transferred, directly or indirectly, by U.S. persons or under the will of a decedent who was a U.S. citizen or resident. A foreign trust for this purpose is one the income of which from sources without the United States is not includible in gross income for U.S. tax purposes. U.S. persons as used here include U.S. citizens or residents, domestic partnerships and corporations, and estates and trusts.

In the case of these foreign trusts, any of their accumulated income, other than income distributable currently, upon distribution to a U.S. citizen or resident is to be taxed to him. The amounts distributed to the U.S. beneficiary are treated as if they had been distributed in the preceding years in which income was accumulated, but are includible in income of the beneficiary for the current year. However, under the bill the tax on such amounts may be computed, at the election of the beneficiary, in either of two ways. One method, referred to here as the "exact" method, is substantially the same as the method provided under present law in the case of distributions subject to the "5-year throwback rule." In addition, however, the bill provides a "shortcut" method which the beneficiary may elect if he does not desire to go through the more extensive computations required by the exact method.

Under the exact method of computation, the tax on the amounts distributed cannot exceed the aggregate of the taxes that would have been payable if the distributions had actually been made in the prior years. This method requires complete trust and beneficiary records for all past years, so that the distributable net income of the trust can be determined for each year, as well as the years in which trust income was accumulated. The beneficiary's own tax then is recomputed for these years, including in his income the appropriate amount of trust income for each of the years (including his share of any tax paid by the trust). Against the additional tax computed in this manner the beneficiary is allowed a credit for his share of the taxes paid by the trust, including a foreign tax credit for income taxes paid foreign countries. Any remaining tax then is due and payable as a part of the tax for the current year in which the distribution was received.

The so-called short-cut method in effect averages the tax attributable to the distribution over a number of years, equal to the number in which the income was earned by the trust. This is accomplished by including, for purposes of tentative computations, a fraction of the income received from the trust in the beneficiary's income for the current year and each of the 2 prior years.[1] The fraction of the income included in each of these years is the same as the number of years in which the income was accumulated by the trust. Thus if the accumulated income is attributable to 10 different years (although the trust may have been in existence over longer than a 10-year period, however), then one-tenth of the amount distributed would be included in the income of the current year and one-tenth in each of the 2 prior years. The additional tax is then computed with respect to these 3 years and the average additional tax for the 3 years deter-

[1] The 2 prior years are included for this purpose only to prevent the current year, in which there may be special circumstances, from having too great an influence on the averaging device used.

mined. This average is then multiplied by the number of years to which the trust income relates, namely, 10 in the example used here. The tax so computed may be offset by a foreign tax credit for any foreign taxes paid by the trust and any remaining tax liability is due and payable in the same year as the tax on the beneficiary's other income in the year of the distribution.

The bill provides certain exceptions from the two computation methods outlined above. First, if short-cut method is used and the number of trust years to which the income relates is less than three, then the average is determined on the basis of any smaller number of years to which the distribution actually related. Second, if the beneficiary was not yet born, with respect to a year to which part of the trust income which is distributed relates, the so-called exact method of computation is not to be used. Similarly, where the beneficiary was not yet alive for the full 3-year period in which the shortcut averaging device is applied, then this averaging device is to be computed on the basis of the shorter period in which the beneficiary was in existence. Third, the bill specifies how prior distributions from foreign trusts to the beneficiary are to be treated in making these computations. Where a taxpayer with respect to an earlier distribution has used the shortcut method and subsequently uses the exact method for another distribution, he is to include in his income for purpses of this exact computation, any income received from the trust in the earlier distribution must be included in his income for any year to which the second distribution relates, to the extent attributable to the years in question. However, where in the current distribution the taxpayer is using the so-called "shortcut" method, he is not required to take into account prior distributions from a foreign trust, whether the exact or shortcut method of taxation was used in the prior computations.

As under present law, the methods of tax computation outlined above are substitutes for including and taxing the entire amount of the distribution in the year actually received. To take advantage of either method the beneficiary at the time of making the election must supply such information with respect to the operation and accounts of the trust for each of the years in which an amount is considered distributed as the Secretary or his delegate may by regulation prescribe. This information is necessary in order to give assurance that the computation is made correctly.

So that the Internal Revenue Service will be aware of the existence of foreign trusts created by American grantors, settlors or transferors, the bill provides that the grantor of an inter vivos trust or the fiduciary of an estate in the case of a testamentary trust, or the transferor is to make a return within 90 days after the creation of the foreign trust or the transfer of money or property to it by an American person, setting forth such information with respect to the foreign trust as the Secretary or his delegate prescribes by regulation as necessary to carry out the provisions of the income tax laws. Failure to supply the information, unless it can be shown that this failure is due to reasonable cause, under the bill is to result in a civil penalty (in addition to any criminal penalty presently provided by law) equal to 5 percent of the amount transferred to the trust but not to exceed $1,000. A similar penalty applies with respect to a return which does not show the information required, even though the return itself is filed.

Generally, these provisions relating to foreign trusts are to apply to distributions made in taxable years of the trust beginning after the date of enactment of this bill. The provisions relating to returns with respect to the creation of, or transfers to, a foreign trust, the civil penalties relating to these returns, and the definitions of U.S. persons and foreign estates and trusts added to the bill, are to be effective on the date of enactment of the bill.

XI. MUTUAL FIRE AND CASUALTY INSURANCE COMPANIES, ETC.

(Sec. 10 of the bill and secs. 821–825, 831, and 832 of code)

A. Reasons for provision

Stock fire and casualty insurance companies have long been taxed at ordinary corporate income tax rates on both investment income and underwriting income. Mutual fire and casualty insurance companies, on the other hand, since 1941 have paid tax under special formulas which do not take into account their underwriting income or loss. Generally, these mutural companies presently are taxed under whichever of two formulas results in the higher tax. Under one formula, they are taxed at ordinary corporate income tax rates on investment income only. Under the other, they pay a tax of 1 percent on their gross investment income plus their premuim income after policyholder dividends, Reciprocal underwriters and interinsurers are taxed only on their investment income and they have a vanishing $50,000 exemption. Mutual companies with total receipts of not more than $75,000 are tax exempt.

The President recommended that stock and mutual fire and casualty insurance companies be taxed on the same basis. He proposed that mutual companies pay tax on their underwriting profits, as well as on their investment income, substantially in the same manner as stock companies.

Your committee's bill to a considerable degree achieves the result sought by the President. Under it, mutual fire and casualty insurance companies are taxed under a modified total income formula. The modifications are required because of the special circumstances of the mutual companies.

While a stock insurance company can pay extraordinary losses not only out of its accumulated profits but out of its paid-in capital, a mutual insurance company can pay extraordinary losses only out of retained underwriting income. As a result, a mutual ordinarily retains a portion of its underwriting income each year for this purpose; the remainder is paid to its policyholders as policy dividends. This accumulated underwriting income constitutes its reserve out of which insurance losses can be paid, and the existence of such reserves is an important protection to the mutual policyholders.

Under the law up to this time, no income taxes have been paid on this retained underwriting income, except (since 1941) to the extent the excess of the alternative 1-percent tax over the tax on investment income in effect taxed part (all, or more than all) of the underwriting income. Similarly underwriting losses may not reduce the tax on investment income. Under the President's proposal, underwriting gains would have been fully taxed as realized. Under the provisions

of your committee's bill, however, these mutual fire and casualty companies will be permitted to set aside a portion of each year's underwriting gain in a special account for protection against losses. This amount will be available to meet certain losses for 5 years, after which, most of any remaining portion will be included in taxable income of the sixth year. A small portion, however, will still be retained in the special account to take care of extraordinary losses. Eventually, these companies will pay tax on their total income, but the tax deferral formula of the bill gives recognition to the mutuals' lack of access to the capital market for funds with which to pay losses. Under the committee bill underwriting losses, in excess of gains, will reduce the tax on investment income.

Under the provisions of your committee's bill mutual companies which have substantial underwriting gains will pay larger taxes than under present law. However, the full impact of taxing their underwriting income will be delayed until 1968. Thus, for a 5-year period only a portion of underwriting income of the mutual fire and casualty industry will be exposed to the Federal income tax. Thereafter, most of the amounts in the account which are not used for the payment of losses within 5 years will be taxed, but this will be offset—or more than offset if the company is growing and its underwriting income is increasing—by the portion of the income of the sixth and subsequent years which is set aside in the protection against loss account.

On the other hand, mutual fire and casualty companies having underwriting losses will, for the first time, be permitted to deduct these losses in full. For such companies the tax under your committee's provisions will be less than under present law which taxes the investment income of a mutual company at full corporate rates even though there is an underwriting loss. On the other hand, a stock company is taxed only on the net amount after deducting an underwriting loss against investment income. Your committee believes that this inequality of treatment should not continue. Under this bill an underwriting loss would be offset against the protection against loss account (or investment income), and any loss not so absorbed would be carried back (though not to a year before 1963) or carried forward, as in the case of corporations generally.

Some mutual insurance companies specialize in insurance against limited risks such as windstorm, hail, or flood, in relatively small geographical areas. Because their operations cover a small area, few storms or floods may occur in some years and the company will then have relatively large underwriting gains; in other years, storms may cause heavy damage in the area of operations and the company will have relatively large underwriting losses. To compensate for this uneven experience your committee's bill permits these concentrated risk companies to defer, in the protection against loss account, a greater proportion of underwriting income than is permitted for ordinary companies. This is to protect them against unusually large losses if, and when, such losses occur.

Your committee's bill does not affect the tax status of very small mutual companies; that is, companies whose total receipts from all sources do not exceed $75,000. Such companies will continue to be exempt from Federal income tax. Companies with total receipts between $75,000 and $300,000 also will be treated much as they are

under existing law; i.e., these companies will pay tax on their investment income only (however, the alternative 1-percent tax of present law will no longer apply). Your committee believes this treatment is justified because these small companies often are of the assessment type and are not required to compute and report their underwriting income on approved forms for State insurance commission purposes. Your committee's bill makes it unnecessary for them to compute their underwriting income in the future. Small companies with total receipts between $300,000 and $900,000 will be taxed both on their investment income and on their underwriting income. However, to provide for a gradual transition to the new tax on their underwriting income, the bill provides a special deduction of $6,000 which decreases as total receipts of the company increase above $300,000. This means that at $900,000 there is no special deduction.

Reciprocal underwriters and interinsurers differ from ordinary mutual insurance companies in that their business is conducted by two entities rather than one. An ordinary mutual insurance company receives all of the premium income from insurance and not only pays losses but conducts directly the operation and management of the insurance activities. The reciprocal underwriter or interinsurer, on the other hand, pays its insurance losses, but an "attorney-in-fact" performs all, or most, of the insurance functions—writing policies, collecting premiums, settling claims, keeping records, etc.—and pays the related expenses, for a portion of the premium income of the reciprocal. Profits realized by the attorney-in-fact from conducting these insurance operations are taxed as ordinary income. However, if that income were earned by a mutual insurance company which performed these operations itself, under existing law it would constitute underwriting income and would not be taxed. Moreover, under present law reciprocal underwriters and interinsurers are not taxed in the same way as ordinary mutuals since they are not subject to the alternative 1-percent tax and have a special exemption. Your committee's bill taxes reciprocal and interinsurers under the same rules that apply to ordinary mutuals; but in recognition of their unique form of operation it permits them in effect to combine the underwriting income of the attorney-in-fact with their own for certain purposes.

Under present law, factory mutual insurance companies are taxed under the same formulas as other mutuals, that is, they pay tax on investment income only (with no deduction for underwriting losses) or under the alternative 1-percent formula. However, because of the very large premium deposits required of their policyholders (typically up to 10 times the amount of an ordinary premium) the investment income of such companies is very large. As a result in practice they never become subject to the alternative 1-percent tax. As in the case of other mutuals, these companies are not permitted to deduct their underwriting losses. This has been a handicap to these companies in years in which they have losses, because the industrial risks which they insure generally are quite large. Your committee's bill taxes factory mutual companies as if they were stock companies, thus permitting them to deduct underwiting losses when they occur. However, since a large portion of each premium is in effect a deposit (which may be returned to the policyholder), in computing their underwriting

profits these companies are to be permitted to determine their premium income on the basis of their schedules of absorbed premium deposits. The amount so determined will be increased by 2 percent for income tax purposes to offset the advantage of the temporary use of deposits which would ordinarily be viewed as premiums received.

B. General explanation of provision

Under present law the tax on a mutual fire and casualty insurance company is, in general, the greater of (1) a tax at the ordinary corporation rates on the company's net income from investments, or (2) a tax of 1 percent of its gross income from both investments and premiums less dividends to policyholders. Under the new provisions the 1-percent alternative tax is eliminated, and the tax is computed at the ordinary corporation rates on the company's total income (investment income and underwriting income) less amounts temporarily set aside in a protection against loss account. Underwriting income of these insurance companies is the excess of premiums received over insurance losses and expenses incurred and dividends paid to policyholders.

There are special provisions for companies with concentrated risks, for small companies, and for reciprocals or interinsurers. Your committee's bill also removes the factory mutuals from the treatment accorded mutual casualty companies generally, and treats them as if they were stock companies, with special provisions for determining what portion of their premium deposits is to be viewed as earned premiums.

1. *Ordinary mutual fire and casualty insurance companies.*—Under the bill taxable income of mutual insurance companies will consist of taxable investment income, statutory underwriting income, and, certain amounts previously set aside for protection against losses. Statutory underwriting income as used in the bill is underwriting income after a special deduction for protection against losses of an amount equal to 1 percent of insurance losses incurred during the year and 25 percent of the ordinary underwriting income.

An amount equal to the special deduction is to be set aside for 5 years in a "protection against loss" account where it can be used only for offsetting losses. At the end of the fifth year, if the amount credited to the protection against loss account has not been absorbed by losses, the portion attributable to the 1 percent of losses and one-half of the portion attributable to the 25 percent of underwriting income will be withdrawn from the account and included in taxable income for that fifth year. The other one-half of the amount representing the 25 percent of underwriting income is retained in the account for a longer period as a cushion against extraordinary losses.

The bill limits the amount which may be accumulated in this account, however. The amount in this account may not be increased above an amount which at the end of any year is more than 10 percent of the earned premiums less dividends to policyholders for that year. If a greater amount were already in the account at the beginning of the year, the account would not be reduced (because of the ceiling) below this amount.

If in any year there is a loss from underwriting loss instead of a gain, the part of the loss resulting from the payment of insurance claims and expenses would be offset directly against taxable investment income. Any amount not so offset and other losses (those resulting from the payment of policyholder dividends or from the special protection against loss deduction) would be charged against the protection against loss account on a first-in, first-out basis. Losses charged against the account would be applied proportionately to amounts representing the 1 percent of losses incurred and the 25 percent of underwriting income.

If in any year there is an extraordinary underwriting loss—more than the investment income for that year and the entire amount in the protection against loss account—the excess will be treated as an ordinary net operating loss, to be carried back against the taxable income of the 3 preceding years or carried forward (first against amounts added to the protection against loss account and then against otherwise taxable income) to the succeeding 5 years, as in the case with any corporation.

In computing their taxable income, mutual companies are to be allowed an unlimited deduction for dividends paid to policyholders.

Under present law mutual insurance companies which are not subject to the 1-percent alternative tax are allowed a special exemption of $3,000, with the tax on taxable incomes between $3,000 and $6,000 gradually increasing until the exemption completely vanishes when taxable income reaches $6,000. The bill increases this special exemption (applicable to the new total of investment and underwriting income) to $6,000 in the case of mutual companies taxable under the general rules of the bill. There also is a gradually increasing tax on taxable incomes between $6,000 and $12,000, so the exemption vanishes when taxable income reaches $12,000.

2. Example.—The computation of taxable income, statutory underwriting gain and the protection against loss account for a 6-year period with successive underwriting gains, may be illustrated as follows, assuming the simplified facts as shown in the following table:

Year	Taxable investment income	Underwriting income	Insurance losses incurred	Additions to protection against loss account
1963	$10	$12	$700	$7+$3 ($10)
1964	11	16	800	8+ 4 (12)
1965	12	12	600	6+ 3 (9)
1966	13	20	600	6+ 5 (11)
1967	14	24	900	9+ 6 (15)
1968	15	20	1,000	10+ 5 (15)

For 1963 the statutory underwriting income would be $2, the underwriting income of $12 minus the 1 percent of incurred losses ($7) and the 25 percent of the underwriting income ($3) credited to the protection against loss account. The taxable income would be $12, the sum of the taxable investment income and the statutory underwriting income. For 1964 the statutory underwriting income would be $4 and the taxable income $15; for 1965 corresponding figures would be $3 and $15; for 1966, $9 and $22; and for 1967, $9 and $23.

For 1968 the statutory underwriting income would be $5 ($20 minus $10 minus $5), but there would be included in taxable income an amount equal to the first item added to the protection against loss account in 1963 ($7), and half of the second item ($1.5), so that for 1968 the taxable income would be $28.5, the sum of the taxable investment income ($15), the statutory underwriting income ($5), and the $8.5 withdrawn from the protection against loss account.

At the end of 1968, therefore, the total amount in the protection against loss account would be $63.5—amounts added for 1964 and the 4 following years, available to offset losses occurring during the next 5 years, and a residual $1.5 to offset any loss which exceeded the entire amount in the account other than that.

If, in the preceding example, for 1966 there had been an underwriting loss excluding policy dividends and the protection against loss deduction of $11, a loss after dividends of $30, and insurance losses incurred had still been $600 the deduction added to the protection against loss account would thus have been 1 percent of $600 or $6 and the statutory underwriting loss would be $36. In that case the portion of the loss not resulting from policy dividends and the protection against loss deduction ($11) would be offset against the taxable investment income of $13, the taxable income for 1966 thus being $2. The remaining portion of the loss ($25) would be charged against the protection against loss account, the $10 added to that account in 1963 and the $12 added in 1964 being eliminated, and of the 1965 addition there would remain $4 and $2. In that case there would be nothing from the protection against loss account to be included in taxable income for 1968 or 1969.

3. Casualty companies with concentrated windstorm, etc., risks.—As stated above, most mutual insurance companies will report and pay a tax currently on the underwriting income remaining after transferring to the protection against loss account 25 percent of underwriting income plus 1 percent of incurred losses. With respect to certain insurance companies whose risks from losses from windstorm, hail, flood, earthquake, or similar hazard, are concentrated in one State, however, your committee's bill permits deferral of more than 25 percent of underwriting income. The percentage of underwriting income which can be credited to the account in their case is determined by dividing the premiums earned on insurance contracts attributable to one State (relating to losses from windstorm, hail, flood, earthquake, or similar hazard) by total premiums earned by the insurance company. If this does not exceed 50 percent, the regular rule is used. If it does, the normal deduction of 25 percent of underwriting income is increased by the excess of that percentage over 50 percent. Thus, under this rule, a company which has 90 percent of its windstorm, etc. risks insured in one State would be permitted to transfer 65 percent (the regular 25 percent plus 40 percent) of its underwriting income to the protection against loss account. However, concentration of risks in one State will not serve to permit a larger percentage of incurred losses to be credited to the protection against loss account.

The overall limitation on the protection against loss account of 10 percent of premiums less policy dividends for the year is not to apply to the amount of underwriting income in excess of 25 percent which these concentrated risk companies add to their protection against loss account. If it did apply it would defeat the objective of allowing a

greater portion of underwriting income to be set aside. In applying the ceiling and also in determining the amount which is to be retained in the account after 5 years, the concentrated risk company is to be treated as if it had transferred only 25 percent of its underwriting income to the account.

4. *Small companies.*—Under the bill, small mutual fire and casualty insurance companies (those whose total receipts—gross investment income, excluding capital gains, plus premiums—exceed $75,000 but do not exceed $300,000) are not taxed on underwriting income. As under present law, these companies will continue to pay tax on investment income only (with no deduction for underwriting losses) but the alternative 1-percent tax will no longer apply. The special exemption of $3,000, with the "notch" rates applying to taxable incomes between $3,000 and $6,000, also will continue in effect.

Despite the general rule described above, the bill permits these small companies to elect to be taxed on total income, including underwriting income, in the same manner as other mutual companies, and such an electing company will similarly be allowed to deduct underwriting losses. Presumably the existence, or expectation, of underwriting losses would be the primary reason for making this election. The election, once made, cannot be changed without the consent of the Treasury Department. On the other hand, a small mutual company which becomes taxable under the general rules because its gross investment income plus premiums exceed $300,000 in a taxable year, again will be taxed as a small company if its income falls below this level, if one condition is met. If while it was taxed under the regular formula it was required to credit a portion of its underwriting income to the protection against loss account, this amount must be taken into income and a tax paid on it before the small company treatment will again apply. To provide consistent tax treatment for these small companies, the bill does not permit loss carrybacks or carryovers to be carried to, from or over a year in which the company was taxable as a small company.

In the case of mutual fire or casualty insurance companies whose total receipts are between $300,000 and $900,000, your committee's bill provides a special vanishing deduction which is to apply to underwriting income only. For a company whose total receipts are just above $300,000, the special deduction will be almost $6,000. As total receipts increase, the $6,000 deduction decreases and finally vanishes when total receipts of the company equal $900,000.

5. *Reciprocal underwriters and interinsurers.*—Under your committee's bill, reciprocal underwriters and interinsurers are in general taxed in the same way as ordinary mutuals, with two important exceptions.

First, reciprocal underwriters and interinsurers may elect to take into account the income of the attorney-in-fact which is attributable to the insurance business of the reciprocal. It accomplishes this by not deducting that part of the fee paid to the attorney-in-fact which is equivalent to the attorney-in-fact's profit from the insurance operation. This election may be made, however, only if the attorney-in-fact is a corporation which keeps its records on the same basis as the reciprocal and certain other requirements are met.

An election by a reciprocal is never to reduce income taxes of the attorney-in-fact. The attorney-in-fact will continue to determine

its tax just as it does under present law except that it must identify income and expense items attributable to the insurance business of the reciprocal.

An electing reciprocal will compute its tax liability on the combined income by applying the formula of this bill to the combined underwriting income, except that 25 percent of underwriting income transferred to the protection against loss account is to be measured by the underwriting income of the exchange only. As an offset to the increased tax due to the inclusion of the income of the attorney-in-fact, the reciprocal may take tax credit for the tax paid by the attorney-in-fact to the extent relating to its income from insurance operations. (Under certain circumstances this may result in a refund to the reciprocal.)

If the combined underwriting account of the reciprocal and its attorney-in-fact shows a loss the ordinary rules of the bill for changing it are to apply. Thus, the loss would be charged first to investment income if it is from the payment of claims or expenses, or to the loss protective account of the reciprocal if it is a loss created by payment of dividends or by the special loss protection deduction.

The inclusion by the reciprocal of the insurance income of the attorney-in-fact can benefit the reciprocal in those cases where the deduction for 1 percent of insurance losses would otherwise exceed the underwriting income, by permitting a larger deferral of tax than would otherwise occur.

The second special feature of the bill relating to reciprocal underwriters or interinsurers permits them to deduct savings credited to individual subscribers' accounts (in the same manner as policyholder dividends paid in cash) if the company would be obligated to pay those amounts promptly to the subscriber if he terminates his contract. This is provided because the "pure," or "classical," reciprocal or interinsurer typically credits the account of each policyholder with savings attributable to his contract and because the policyholder has a legal right to receive the amount so credited if he withdraws from the exchange. Because amounts credited to the account of an individual subscriber represent reductions to him in the cost of insurance, the bill provides that for income tax purposes the subscriber must reflect this reduction when the credit is made. The bill in effect requires the business policyholder of a reciprocal to take into account for purposes of computing his income for insurance costs by the amount credited to his account by the reciprocal.

This deduction for credited savings, as stated above, is to be available only in case of so-called "pure" or "classical" reciprocals or interinsurers where the credits, as a matter of actual practice, are paid to policyholder subscribers who terminate their contracts. An ordinary reciprocal which may nominally meet the requirement of the statute would not be entitled to this deduction where savings credited to subscribers are not in fact returned to them when they terminate their policies.

6. Factory mutual insurance companies.—The bill amends the law with respect to factory mutual insurance companies in two important respects. First, commencing in 1963, these companies will be treated for tax purposes as if they were stock companies. This means that they will report their underwriting income in full in the year earned, and their underwriting losses after 1962 will be deductible in full.

Secondly, the method of computing premium income of factory mutuals is modified to conform more closely to the actual operation of these companies. This is accomplished by permitting them to determine their premium income on the basis of their schedule of absorbed premium deposits. The amount thus determined is then to be increased under the bill by 2 percent of absorbed premiums for income tax purposes. For example, a factory mutual might require a premium deposit of $1,000 and its experience indicates it will absorb 12 percent of the premium deposit each year during the term of the policy. Under existing law, in the case of a 3-year policy, the factory mutual would realize earned premiums of $333.33 each year (one-third of the premium deposit) and would deduct returns to policyholders as if they were dividends. Actually, however, the factory mutual absorbs only 12 percent of the premium deposit, or $120 each year. Under the bill, this factory mutual will report for income tax purposes $122.40. This bill also provides for an adjustment in the unearned premium account of the factory mutual for returns of unabsorbed premium deposits to policyholders upon termination of their policies. This return of unabsorbed premium deposit is viewed as analogous to a dividend or a payment similar to a dividend.

7. *Mutual marine insurance companies.*—Mutual marine insurance companies have been taxed as stock insurance companies for many years and your committee's bill continues this treatment for them. However, a question has arisen as to whether a company which was a mutual marine insurance company under prior law is still to be treated as such a company if it engages in substantial multiple line underwriting. In order to clarify the law for the future, your committee's bill provides that any mutual marine insurance company which was taxed as a stock company for a period of at least 5 years may elect to continue to be taxed under the same formula in the future.

8. *Effective dates.*—The amendments made by this section are to apply with respect to taxable years beginning after December 31, 1962 (except that the effective date relating to mutual marine insurance companies is taxable years beginning after December 31, 1961).

XII. DOMESTIC CORPORATIONS RECEIVING DIVIDENDS FROM FOREIGN CORPORATIONS

(Sec. 11 of the bill and secs. 902 and 78 of code)

A. Reasons for provision

The President in his tax message to Congress last year stated that the method by which the credit for foreign income tax is computed in the case of dividends involves, in effect, a double allowance for foreign income taxes and should be corrected.

The problem arises when the foreign tax rate is below the U.S. tax rate and results from the fact that the amount paid in foreign taxes not only is allowed as a credit in computing the U.S. tax of the corporation receiving the dividend, but also is in effect allowed as a deduction (since the dividends can only be paid out of income remaining after payment of the foreign tax).

The problem can be illustrated by assuming that a foreign government imposes a 30-percent tax with respect to $1,000 of income of a

corporation. This would leave $700 of the $1,000 out of which a dividend could be paid to a U.S. parent corporation. If the applicable U.S. tax rate is 52 percent, the American tax on this $700 before the allowance of any foreign tax credit would be $364. On the other hand, if the $1,000 of income had been earned by a branch of the U.S. corporation, the entire $1,000 would be subject to U.S. tax before allowance of any foreign tax credit. Thus, in this case the tentative U.S. tax would be $520, or $156 more than in the case of the foreign subsidiary.

In the case of the foreign subsidiary, the foreign tax allowed as a credit is limited to the same proportion of the tax which the income included in the American tax base is of the total income.[1] Thus, the allowable credit in the case of the foreign subsidiary is limited to seven-tenths of the $300 or is limited to $210. As a result the final U.S. tax on the dividend is $154 ($364 minus $210). This U.S. tax of $154, plus the foreign tax of $300, results in a total tax of $454, which is $66 less than the full $520 tax which would be paid by a domestic corporation operating in this country, or operating abroad through a branch.[2]

The size of this tax differential which exists in the case of dividends from foreign subsidiaries at the present time varies with the size of the foreign tax rate. As shown in table 1, the tax differential disappears either when the foreign tax rate equals or exceeds the U.S. tax or when there is no foreign tax imposed at all. The maximum tax differential, given a 52-percent U.S. tax rate, occurs when the foreign tax rate is half that, or 26 percent. The differential at this point is 6.7 percentage points.[3] Where dividends are received by a domestic corporation from its subsidiary, which in turn has received its income from a subsidiary, the maximum tax differential (given the 52-percent U.S. tax rate) amounts to 11.93 percentage points.

TABLE 1.—*Rate differential enjoyed with respect to dividends from foreign subsidiaries with various selected foreign income tax rates and present 52-percent U.S. rate*

Income before tax	Foreign tax	Income available for dividend	U.S. tax before credit	Credit against U.S. tax	U.S. tax	Total tax	Rate differential enjoyed by foreign subsidiary
							Percentage points
$100	0	$100	$52.00	0	$52.00	$52.00	0
$100	$5	95	49.40	$4.75	44.65	49.65	2.35
$100	10	90	46.80	9.00	37.80	47.80	4.20
$100	20	80	41.60	16.00	25.60	45.60	6.40
$100	26	74	38.48	19.24	19.24	45.24	6.76
$100	30	70	36.40	21.00	15.40	45.40	6.60
$100	40	60	31.20	24.00	7.20	47.20	4.80
$100	50	50	26.00	25.00	1.00	51.00	1.00
$100	52	48	24.96	24.96	0	52.00	0

[1] This is the result of the decision in *American Chicle Company* v. *U.S.*, 316 U.S. 450 (1942).

[2] As indicated above, the U.S. tax before credit in the case of the branch would be $520. After allowing the $300 foreign tax credit in this case, the final U.S. tax would be $220 which, with the $300 of foreign tax means a total tax of $520.

[3] The tax differential represents the difference between the U.S. and foreign tax rates, multiplied by the income omitted from the U.S. tax base.

Your committee agrees with the President that in the interest of uniform tax treatment this double allowance in the case of dividends from foreign corporations should be removed. This is accomplished by providing that where a taxpayer elects the foreign tax credit, he must increase, or "gross-up," his U.S. tax base by including in it the amount of foreign income paid in taxes which is attributable to the dividend received. Thus, in the example cited above, the tentative U.S. tax would be computed on the basis of $1,000, instead of $700, and then the full $300 of foreign taxes would be allowed as a tax credit, in the same way as branches of U.S. corporations are treated at the present time.

Two relatively minor technical corrections recommended by the administration are also included with this provision. One of these involves the repeal of a subsection (sec. 902(d)) of one of the foreign tax credit provisions, which makes the foreign tax credit available in limited cases with respect to royalty income received from a foreign subsidiary. This royalty income is entitled to this foreign tax credit only where the domestic corporation owns all of the stock of the subsidiary. The provision granting this treatment in the case of royalty income was adopted in 1954 in order to grant relief in a case where under currency exchange restrictions, a corporation was prohibited from distributing its earnings. The retention of this provision appears undesirable, since it has the effect of allowing a foreign tax credit before actual dividend distributions have been made. Your committee's bill, therefore, repeals this subsection.

Second, the bill also follows a recommendation of the administration relating to the interrelationship of the foreign tax credit and the intercorporate dividends received deduction. The problem arises here where a foreign corporation derives 50 percent or more of its income from sources within the United States. In such a case a domestic corporation receiving dividends from it is eligible for the 85-percent intercorporate dividends received deduction. This deduction is available with respect to the proportion of the income determined to be from sources within the United States. However, all of the remaining income is treated as income from sources without the United States for which a foreign tax credit is available, including the 15-percent amount remaining after the allowance of the intercorporate dividends received deduction which, for that purpose, was treated as income from sources within the United States. The administration recommended that this 15 percent of domestic source income, remaining after the dividend received deduction is allowed, retain its domestic source character rather than being reclassified as foreign source income for purposes of the foreign tax credit. Your committee's bill makes this modification.

B. General explanation of provision

1. Elimination of double allowance.—The provision adds a new section to the code (sec. 78) which provides that if a domestic corporation elects to take the foreign tax credit (rather than a deduction for foreign taxes) it must take into its gross income an amount equal to the taxes of the subsidiary (or an amount equal to the taxes of its subsidiary's subsidiary) it is considered, or deemed, to have paid for

purposes of the foreign tax credit provision. Thus, for a domestic corporation to claim a foreign tax credit for foreign taxes paid by its subsidiary or a subsidiary of that subsidiary, it must "gross up" its dividend income received by the amount of the foreign income, etc., taxes attributable to it.

Other provisions of the code (sec. 902 (c), (a), and (b)) are also amended to carry out fully the "gross-up" referred to in the prior paragraph. Thus, the definition of the term accumulated profits for purposes of the foreign tax credit is modified to include the income and similar taxes imposed by a foreign country (or U.S. possessions) which are taken into account by the domestic corporation.

2. Dividends from U.S. sources.—The bill amends the rules used in determining whether income is from within or without the United States in the case of a foreign corporation which has received 50 percent or more of its gross income for the 3 prior years from sources within the United States. In such a case, the 85-percent intercorporate dividends received deduction is available with respect to the proportion of its income which its income for the 3-year period derived from sources within the United States bears to its income from all sources. However, under present law all of such a corporation's income, to the extent it exceeds the 85-percent deduction allowed for intercorporate dividends received, is treated (for purposes of the foreign tax credit) as income from sources without the United States. Thus, the 15 percent for which no intercorporate dividends received deduction is allowed, although for purposes of the prior computation treated as from sources within the United States, is for this purpose treated as foreign source income. The bill corrects this technical deficiency by providing that the amount treated as foreign source income in such a case is only the remaining income in excess of this 15 percent.

3. Royalty income eligible for foreign tax credit.—The bill repeals the provision of present law (sec. 902(d)) which treats as a distribution (and, therefore, eligible for the foreign tax credit) royalty payments received by a domestic corporation from a 100-percent owned subsidiary engaged in manufacturing, production, or mining.

4. Effective date.—The provisions referred to above are applicable to *all* dividends received by a domestic corporation after December 31, 1964. They also are to apply to *certain* dividends received by the domestic corporation in the period before January 1, 1965, but only in its taxable years beginning after December 31, 1962. For a calendar year corporation this latter category includes certain dividends received in the calendar years 1963 and 1964. In the case of dividends received in these years the "gross-up" and other changes made by this provision are to apply only to the extent that the dividends are treated for tax purposes as made out of the accumulated profits of the foreign corporation for taxable years beginning after December 31, 1962. Dividends received by a foreign corporation from its subsidiary before January 1, 1965, which are paid out of the subsidiary's profits from before 1963, are to be treated as paid out of the first foreign corporation's profits from before 1963 if it in turn pays the dividends to the domestic corporation before January 1, 1965.

XIII. EARNED INCOME FROM SOURCES OUTSIDE THE UNITED STATES

(Sec. 12 of the bill and secs. 911 and 72(f) of the code)

A. Reasons for provision

Under present law an individual citizen of the United States who is a bona fide resident of a foreign country may exclude from his U.S. tax base his entire earned income from sources outside of the United States. In addition, an individual who goes abroad, but does not establish a foreign residence, may exclude from his U.S. tax base his earned income up to $20,000 a year if he remains abroad for a period of 17 out of 18 consecutive months.

The President recommended that in the case of citizens living abroad in developed countries there be no exclusion for income earned abroad. In the case of less developed countries he would keep the present exclusion of up to $20,000 a year in the case of those who are abroad 17 out of 18 months, and also provide the same $20,000 ceiling with respect to those who are bona fide residents of a foreign country.

Your committee's bill provides a ceiling on the exclusion for income earned abroad. However, it has not attempted to distinguish between U.S. citizens residing or present in developed and those in less developed countries. As a result, it has retained the 17-out-of-18-month provision of present law without any major change in the presently applicable $20,000 ceiling. In the case of a bona fide resident of a foreign country your committee's bill also provides the same $20,000 limitation for the first 3 years the individual is abroad. However, if the individual is abroad for an uninterrupted period of more than 3 consecutive years a higher ceiling of $35,000 is provided. Thus, during the first 3 years an individual is abroad the exclusion will be the same, whether the individual is a bona fide resident of the foreign country or merely there for 17 out of 18 months. However, in recognition of the fact that those who are abroad for longer periods of time are more dependent on the foreign economy, and less upon the U.S. economy, the higher ceiling of $35,000 is provided in the case of these longer stays.

A second recommendation of the administration in this area relates to pensions and deferred compensation paid to U.S. citizens, after they are back in the United States, but with respect to periods of time they were abroad.

In the case of pensions generally, an employee receives back over his period of life expectancy (or in some cases in the first 3 years) the amount he paid toward his pension. The remainder of the pension payments he receives, consisting of contributions by the employer and interest on the funds while they were accumulating, is taxable to him as the pension or annuity payments are received.

In the case of a citizen who has been a bona fide resident of a foreign country, or been in a foreign country for a period of 17 out of 18 months or more, the employer contributions toward the pension fund during the period he was abroad are treated in the same manner as his own contributions and, therefore, are not taxable to him when he draws his pension or annuity upon retirement. This is true even though he may be living in the United States next to someone who

has worked for the same employer in the United States and is fully taxable on contributions made by the same employer.

To remove this discrimination the bill provides that contributions by an employer will, to the extent that they relate to future employment, be fully taxable to the employee when he receives the pension payments reflecting these contributions. Thus, for the future even though employer contributions are attributable to a period when the employee was abroad after 1962, these contributions by the employer will be taxable to him in the same manner as in the case of a domestic worker also receiving a pension. This will be true whether the employee is living in the United States, or abroad, at the time of the receipt of the pension payment.

Also, under your committee's bill deferred compensation arrangements where an individual receives the deferred compensation after the end of the taxable year following the year in which the services were performed is not to be eligible for the exclusion for income earned abroad. The purpose of the exclusion is to provide a special inducement for American citizens or residents to hold employment abroad. Your committee sees no reason, however, to provide this special inducement long after the period in which the employment occurred. Moreover, this will treat deferred compensation under the exclusion the same as qualified pensions.

B. General explanation of provision

1. Ceiling on earned income exclusion.—Your committee's bill places a ceiling on the amount which may be excluded from income in the case of a citizen of the United States who is a bona fide resident of a foreign country or countries. The bill provides that the total amount which may be excluded with respect to the first 3 years an individual is abroad as a bona fide resident is $20,000 a year. This is the same ceiling which presently is applicable in the case of citizens or residents of the United States who are abroad for a period of 17 out of 18 months. However, in the case of the U.S. citizen who is a bona fide resident of a foreign country or countries for more than 3 years, the total amount which may be excluded in this case is to be $35,000 under the bill instead of $20,000. This higher ceiling is to apply with respect to any portion of a taxable year remaining after the individual has been a bona fide resident of a foreign country or countries for the uninterrupted 3-year period. Where at the time of the passage of this legislation the individual already has been a bona fide resident for 3 years or more, this higher ceiling will, of course, become applicable immediately.

In applying either the $20,000 or $35,000 ceilings under community property laws the total community income excludable may not exceed the amount which would be excludable if this income were not community income. Thus, one $20,000 or $35,000 ceiling will apply with respect to the husband's earnings abroad even though under community property law, half of this income is the income of the wife. However, if both husband and wife are abroad and earn income, separate ceilings will be applied with respect to their earnings attributable to the services of each.

2. Deferred compensation.—Under present law the bona fide resident rule and the 17- out of 18-month rule work somewhat differently in determining the year to which the exclusion relates. The bona fide

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resident rule at present provides an exclusion without limit for amounts received from sources without the United States which are "attributable" to the period when the U.S. citizen was a bona fide resident of a foreign country. This means that deferred compensation attributable to a period of foreign service is excludable even though received many years after the period of service.

The 17- out of 18-month rule, however, because of the $20,000 ceiling, has been interpreted as limiting the exclusion which an individual may receive to the proportion of the year, during which the payment was received, in which the individual was abroad. Thus, where the individual receives deferred compensation after he is back in the United States for an entire year, no exclusion is available. Moreover, in this latter case, hardship situations have occurred where an individual, who has returned to the United States early in a year, has received payments attributable to service in the prior year, but because the individual is in the United States most, or all, of the year little, or no, exclusion is available with respect to this income.

Your committee eliminates the problems referred to above by attributing the income, for purposes of applying the dollar limitation on the exclusion, to the year in which the service is performed. This means that the exclusion, merely because the individual has returned to the United States before receiving the payment, will not be denied. However, deferred compensation is made ineligible for the exclusion by providing that no exclusion will be allowed for amounts received more than 1 year after the close of the taxable year in which the services are performed.

3. Pension income.—The provision of present law dealing with annuities (sec. 72(f)) provides that in determining what the employee or annuitant paid for an annuity contract, there is to be included contributions of the employer, if, had these contributions been paid to the employee in the first instance, they would not have been taxable to him. This provision generally has the effect of excluding employer contributions to a pension plan from tax where the employee is abroad and qualifies for the exclusion.

The bill nullifies this section by providing that the exclusion for income earned abroad is not to be available in the case of amounts received as pensions or annuities or amounts which otherwise would be included in gross income in the case of beneficiaries of tax-exempt trusts (sec. 402(b)), beneficiaries under nonqualified annuities (sec. 403(c)), or beneficiaries under certain forfeitable contracts purchased by exempt organizations (sec. 403(d)).

The bill also makes it clear that the tax-free status of employer contributions will be continued in the case of contributions made after December 31, 1963, to the extent that they provide pension or annuity credits where these credits are attributable to services performed on or before that date if the pension or annuity plan provisions were in existence on February 1, 1962.

4. Effective date.—The changes made by this provision are to apply to amounts received after December 31, 1962, but only to the extent that these amounts are attributable to services performed after that date or services performed on or before that date, where before February 1, 1962, there did not exist a right to receive these amounts.

XIV. CONTROLLED FOREIGN CORPORATIONS

(Sec. 13 of bill and secs. 951–958 of code)

A. Reasons for provision

Under present law foreign corporations, even though they may be American controlled, are not subject to U.S. tax laws on foreign source income. As a result no U.S. tax is imposed with respect to the foreign source earnings of these corporations where they are controlled by Americans until dividends are paid by the foreign corporations to their American parent corporations or to their other American shareholders. The tax at that time is imposed with respect to the dividend income received by the American shareholder, and if this shareholder is a corporation it is eligible for a foreign tax credit with respect to the taxes paid by the foreign subsidiary. In the case of foreign subsidiaries, therefore, this means that foreign taxes are paid currently, to the extent of the applicable foreign income tax, and not until distributions are made will an additional U.S. tax be imposed, to the extent the U.S. rate is above that applicable in the foreign country. This latter tax effect has been referred to as "tax deferral."

The President in his tax message last year questioned the desirability of providing tax deferral with respect to earnings of U.S.-controlled companies except in the case of investments in less developed countries. However, his primary emphasis was on removing tax deferral in the case of what have been called "tax havens." In this respect he stated:

> The undesirability of continuing deferral is underscored where deferral has served as a shelter for tax escape through the unjustifiable use of tax havens such as Switzerland. Recently more and more enterprises organized abroad by American firms have arranged their corporate structures—aided by artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights, the shifting of management fees, and similar practices which maximize the accumulation of profits in the tax haven—so as to exploit the multiplicity of foreign tax systems and international agreements in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad.

In this area the President recommended the:

> * * * elimination of the tax haven device anywhere in the world, even in the underdeveloped countries, through the elimination of tax deferral privileges for those forms of activities, such as trading, licensing, insurance, and others, that typically seek out tax haven methods of operation. There is no valid reason to permit their remaining untaxed regardless of the country in which they are located.

Your committee's bill does not go as far as the President recommendations. It does not eliminate tax deferral in the case of operating businesses owned by Americans which are located in the economically developed countries of the world. Testimony in hearings before your committee suggested that the location of investments in these countries is an important factor in stimulating American exports to the same areas. Moreover, it appeared that to impose the U.S. tax currently

on the U.S. shareholders of American-owned businesses operating abroad would place such firms at a disadvantage with other firms located in the same areas not subject to U.S. tax.

Nevertheless, the testimony before your committee did convince it that many have taken advantage of the multiplicity of foreign tax systems to avoid taxation by the United States on what could ordinarily be expected to be U.S. source income. In part your committee has met this problem elsewhere in this bill (sec. 6) through the addition of a new subsection to the existing section 482 setting up specific factors to be taken into account in more accurately allocating income from purchases and sales of goods between American corporations and their controlled foreign subsidiaries. However, certain of the provisions set forth in this section are also designed to meet this problem of diversion of income from U.S. taxation. This is true, for example, of the provisions taxing to the U.S. shareholders foreign income arising from controlled foreign corporations in the case of insurance on American risks. This is also true of the provision taxing income derived by controlled foreign corporations from patents, copyrights, etc., developed in the United States.

Your committee has also concluded that U.S. tax should be imposed currently, on the American shareholders, on income which is held abroad and not used in the taxpayer's trade or business unless, in accord with the policy enunciated by the President, it is invested in businesses in less developed countries. Because of this your committee's bill taxes to U.S. shareholders investment-type income not invested in less developed countries and also income which may arise from the active conduct of a trade or business if the income is not reinvested in the same business (outside of the United States) or in a less developed country.

A third objective of the tax measures described below is to prevent the repatriation of income to the United States in a manner which does not subject it to U.S. taxation. This accounts for section 16 of this bill which gives assurance that upon the liquidation of a corporation, the redemption of stock, or the sale of stock in a controlled foreign corporation the earnings and profits of the corporation—not previously subject to tax by United States—are to be so taxed to the extent of the excess of the U.S. tax over the foreign tax. This objective also accounts for some of the features of this provision, which deny tax deferral where funds are brought back and invested in United States in a manner which does not otherwise subject them to U.S. taxation.

Your committee also has ended tax deferral for American shareholders in certain situations where the multiplicity of foreign tax systems has been taken advantage of by American-controlled businesses to siphon off sales profits from goods manufactured by related parties either in United States or abroad. In such cases the separation of the sales function is designed to avoid either U.S. tax or tax imposed by the foreign country.

B. General explanation of provision

1. In general.—The bill provides that certain undistributed income of controlled foreign corporations is to be included in the income of U.S. shareholders in the year the income is earned by the foreign corporation, whether or not it is distributed. In these cases, the share-

holders are permitted foreign tax credits to the same extent as if actual distributions had been made. The U.S. shareholders, or "U.S. persons" as they are called in the bill, are defined as including U.S. citizens and residents and domestic corporations, partnerships, and estates or trusts. As indicated, this income is taxed to the U.S. shareholders only in the case of "controlled foreign corporations." A foreign corporation is controlled for this purpose when more than 50 percent of the combined voting power of all classes of stock is owned directly or indirectly (through the stock attribution rules specified) by U.S. persons on any day of the taxable year of the corporation. (A special, additional rule provided in the case of insurance is discussed subsequently.)

Not all U.S. persons who are shareholders in such a controlled foreign corporation, however, are to have attributed to them the specified types of foreign income of a controlled foreign corporation. This is to be done only in the case of those having on any day during the year a stock ownership of 10 percent or more of the combined voting power of all classes of stock, or of the total value of shares of all classes of stock. This *de minimis* rule prevents the attribution of the undistributed income back to the shareholders where their interest is small and their influence on the corporation's policy is presumably negligible. The 10-percent ownership test is determined by applying stock ownership attribution rules set forth in the bill.

There are two groupings of income under this provision which may result in income being attributed to the shareholders and their being taxed on it. The first category of such income is known in the bill as "subpart F income." This consists of: (1) income derived from insurance on U.S. risks on property or persons; (2) income derived from patents, copyrights, and exclusive formulas and processes which were developed in the United States; and (3) certain so-called net foreign base company income. In general, this foreign base company income consists of income from passive sources—such as dividends, interest, rents, etc., and also certain income from sales subsidiaries (to the extent these income categories are not reinvested in less developed countries). This subpart F income under the bill is attributed to 10-percent U.S. shareholders and taxed to them in largely the same manner as dividends.

A second category of earnings may also give rise to the corporation's income being taxed to 10-percent-or-more U.S. shareholders. This is the increase in the earnings invested during the year in what is called "nonqualified property." In general terms investments in nonqualified property consist of investments not required in the taxpayer's trade or business and not invested in a less developed country. Nonqualified property also includes most investments in the United States whether or not the property is used in the taxpayer's trade or business. The earnings representing an increase in investments in nonqualified property are treated first as coming out of the subpart F income already taxed. To the extent of this income, therefore, earnings representing this nonqualified property category do not result in any additional tax for the shareholders. Only when the earnings invested in nonqualified property exceed the accumulated balance of any subpart F income (including both subpart F income for

the current year and any prior years) which was not previously offset by the nonqualified property category is the income to be taxed to the U.S. shareholders.

Just as the invested earnings in nonqualified property are treated as being first out of subpart F income, so actual dividend distributions are treated first as being paid out of the earnings invested in nonqualified property, then out of subpart F income, and only finally, if any balance remains, out of the accumulated earnings of the corporation which have not already been taxed to the shareholders. Only when the actual dividends are treated as paid out of this latter category do they represent taxable dividends to the shareholders.

The earnings of a corporation classified as subpart F income, or as earnings invested in nonqualified property, give rise to taxable income to the shareholders only for the portion of earnings represented by the portion of the year in which the corporation was a controlled foreign corporation. Also, it will be necessary to maintain separate balances of earnings and profits with respect to different shareholders during the year, because there may be differences as to whether they are 10-percent stockholders or not, and also because such stockholders may increase or decrease their stockholdings during the year.

2. Income derived from insurance of U.S. risks.—Since the passage of the Life Insurance Company Income Tax Act of 1959, which for the first time in many years imposed a tax on underwriting gains of these companies, it is understood that a number of the companies involved have attempted to avoid tax on the gains by reinsuring their policies abroad. In other cases the tax has been avoided by placing the initial policy with a foreign insurance company either controlled by an American insurance company or controlled by other American businesses.

To meet this problem your committee's bill provides that where a controlled foreign corporation receives premiums or other consideration for reinsurance or the issuing of insurance or annuity contracts on property in, or residents of, the United States the income attributable to this is to be taxed to the U.S. shareholders as a part of subpart F income.

The bill also covers the type of situation where the controlled foreign corporation does not hold the policies involving U.S. risks but instead holds other policies which, by arrangement with another unrelated corporation. it has received instead of the insurance involving the U.S. risks, while the unrelated corporation holds the policies involving the insurance on property in, or residents of, the United States.

In the case of insurance there also is an alternative definition of a controlled foreign corporation. Under the alternative if U.S. persons hold from 25 to 50 percent of the stock, any income from insurance or reinsurance on U.S. risks is included in income taxed as subpart F income where the U.S. risks represent 75 percent of the gross amount of all premiums and other considerations with respect to risks held by the company. This alternative rule for control is designed to cover cases where the principal business is the U.S. risks but the control is decreased in order to avoid the application of this provision.

The income subject to tax in the hands of the shareholders in the case of life insurance companies is total gain from operations to the extent attributable to U.S. risks. In effect this represents all (not 50 percent) of the underwriting income as well as net investment income.

In the case of fire, casualty, and similar insurance companies, the income subject to tax will be the same whether the company is a mutual or stock company since the stock company rules for this purpose are made applicable to the mutual. Certain deductions generally allowed domestic insurance companies will not be allowed in the case of these foreign operations. The deductions which are disallowed for life insurance business include the operations loss deduction, the deduction for certain nonparticipating contracts, the deduction for group life, accident, and health insurance, and the small business deduction. Other modifications are also provided. The income ascribed to the shareholders will be the income relating to the insurance or reinsurance on the U.S. risks, taking into account expenses, losses, and deductions properly allocable to this income.

3. Income from U.S. patents, copyrights, etc.—The second component of the subpart F income which will be taxed to the U.S. shareholders in the case of controlled foreign corporations is income from U.S. patents, copyrights, and exclusive formulas and processes. For the income from these patents, copyrights, etc., to be included they must have been substantially developed, created, or produced in the United States, or, alternatively, acquired directly or indirectly from related U.S. persons. Your committee concluded that it was desirable to tax this income to the U.S. shareholders on the grounds that where a patent, copyright, etc., was developed or created in the United States, it is likely that, if it were not for lower taxes abroad, the rights to it would still be held by the domestic company with this company merely licensing its use by the foreign corporation. This, of course, would result in rental or royalty income taxable to the U.S. company.

The income to be taxed here is that derived from the license, sublicense, sale, exchange, use, or other means of exploitation of the patent, copyright, exclusive formula, or process. From this income there is to be deducted the expenses incurred by the controlled foreign corporation, including taxes paid foreign countries, with respect to this income, and any amortization or depreciation of the cost of the patent, copyright, etc.

Income from patents, copyrights, etc., is attributed to U.S. shareholders not only where the foreign corporation receives a royalty or similar payment for the use of the property, but also where the foreign corporation itself uses the patent, copyright, or exclusive formula or process in the manufacture of goods and derives income from the sale of the manufactured articles. In such a case the income derived from the patent, etc., is to be considered as the amount which would be obtained as a gross rent, royalty or other payment in an arm's-length transition with an unrelated person from the similar use of this patent, etc. The amount so determined is not intended to be merely a percentage of the taxable income derived from the products manufactured and sold and, therefore, there is no intention that manufacturing, production or similar expenses are to be taken into account in determining the net royalty or rental payment.

4. Net foreign base company income.—The two income components of subpart F income discussed above are in both cases taxed to the U.S. shareholders without any reductions for reinvestment. What is described here as "foreign base company income," however, may be reduced for qualified investment in less developed countries made during the taxable year (or in the first 2½ months thereafter). This

accounts for the reference to "net" in this income category. The investments which may be made in less developed countries in this case are the same as two of the categories described in connection with reinvestments permitted in the case of qualified property. This is developed further below.

The foreign base company income consists of two basic parts: passive investment income, or more precisely "foreign personal holding company income" with certain modifications described below, and "foreign base company sales income."

Your committee while recognizing the need to maintain active American business operations abroad on an equal competitive footing with other operating businesses in the same foreign countries, nevertheless sees no need to maintain deferral of U.S. tax where the investments are portfolio types of investments, or where the company is merely passively receiving investment income. In such cases there is no competitive problem justifying postponement of the tax until the income is repatriated.

The passive income referred to here is the same as "foreign personal holding company income" except that rental income is included whether or not rents represented more than 50 pecent of the gross income involved. An exception is also made for income of banks and bank subsidiary organizations since in such cases the receipt of interest and other similar types of income do not result from passive investments. Those excluded by this provision are corporations organized and doing business under the banking and credit laws of a foreign country. Also excluded are foreign corporations where 50 percent or more of their stock is held by domestic corporations organized under section 25(a) of the Federal Reserve Act or having an agreement with the Board of Governors of the Federal Reserve System under the same section of the Federal Reserve Act. These are the so-called Edge Act corporations. Under the bill all of their stock (except qualifying shares) must be owned by a national or State bank which is a member of the Federal Reserve System.

The "foreign base company sales income" referred to here means income from the purchase and sale of property without any appreciable value being added to the product by the selling corporation. This does not, for example, include cases where any significant amount of manufacturing, installation, or construction activity is carried on with respect to the product by the selling corporation. On the other hand, activity such as minor assembling, packaging, repackaging, or labeling would not be sufficient to exclude the profits from this definition.

The bill provides that this sales income is to be taken into account as foreign base income only where it represents at least 20 percent of the gross income of the foreign corporation. The 20 percent is to be computed without taking into account the passive income of the foreign corporation.

The sales income with which your committee is primarily concerned is income of a selling subsidiary (whether acting as a principal or agent) which has been separated from manufacturing activities of a related corporation merely to obtain a lower rate of tax for the sales income. As a result, this provision is restricted to sales of property to a related person or purchases of property from a related person. Moreover, since the lower tax rate for such a company is likely to be

obtained through purchases and sales outside of the country in which it is incorporated, the provision is made inapplicable to the extent the property is manufactured, produced, grown, or extracted in the country where the corporation is organized or where it is sold for use, consumption, or disposition in that country. Mere passage of title, however, is not intended to be determinative of the location of the purchase or sale for this purpose.

Where the foreign base company gross income (before deduction for any reinvestment) is less than 20 percent of the gross income it is not taken into account in computing subpart F income. On the other hand, where it exceeds 80 percent of the gross income of a corporation, the entire gross income (less deductions) is to be classified as foreign base company income. Where this income is from 20 percent to 80 percent of the company's gross income, only the foreign base company income is taken into account. These rules are similar to those set forth in an earlier provision (sec. 7) of this bill with respect to foreign personal holding company income. Thus, where this foreign base company income is relatively minor, the shareholders will not be taxed on any of it; where it is a major factor, they are to be taxed on the entire income of the corporation. Otherwise only the foreign base company income is taken into account.

The net foreign base company income which may constitute subpart F income is the foreign base company less investment in qualified property in less developed countries. The qualified investments income are investments in stock in a controlled corporation in a less developed country or any investments which are required because of restrictions imposed by a less developed country (including investments previously so required which would result in a substantial loss if now withdrawn). These are two of the categories in which reinvestment is permitted in the case of the next category of income described below, and are discussed in greater detail at that point. In determining these reinvestments taken into account it is only the increases over the investments held at the end of the preceding year which are taken into account.

5. *Earnings invested in nonqualified property.*—The categories of income referred to up to this point are the components of the "subpart F income." As previously indicated, these are taxed to the shareholders in all cases. In addition, however, the increase in earnings invested in nonqualified property may also be taxed to the shareholders. However, this income is taxed to the shareholders only to the extent it exceeds any balance of subpart F income remaining (not only for the current year but also for prior years) which has not previously been offset by earnings invested in nonqualified property. In this manner it is possible to prevent the same amount from being attributed to the shareholder for tax purposes more than once. The rule provided here in effect assumes that any increases in investments in nonqualified property are made first out of this subpart F income already taxed to the shareholders.

Since the concept here is merely to tax to the U.S. shareholders the earnings and profits of the corporation since the end of 1962, the investments in nonqualified property taken into account are only those which are in excess of earnings and profits accumulated in taxable years beginning after December 31, 1962. With respect to any year, therefore, the increase in nonqualified property is the excess of property

of this type at the end of the current taxable year over property of this type as of the end of the prior taxable year.[1]

Since it is not intended that this provision in any sense be retroactive, only nonqualified property acquired after December 31, 1962, is taken into account. This means that a record will have to be maintained of nonqualified property as of December 31, 1962, in order to keep these amounts of nonqualified investments, previously made, from resulting in a tax in subsequent years.

Your committee in determining what constitutes qualified property concluded that for competitive reasons the foreign corporation should be able to expand its investments in the same trade or business (or substantially the same trade or business) wherever it was located. Thus, money or other property located outside of the United States which is ordinary and necessary to the active conduct of a qualified trade or business of the controlled corporation is considered qualified property. In order to prevent foreign corporations from starting relatively small trades or businesses (incurring relatively small penalties in denial of deferment) and then permitting additions in later years to these investments to qualify as investments in the corporation's "trade or business," the bill provides a 5-year "seasoning" rule. Thus, only where the corporation has engaged in a trade or business for the past 5 years with additional investments in it qualify as in the "corporation's trade or business." However, any trade or business in which the foreign corporation was engaged in on December 31, 1962, will also qualify without regard to the 5-year rule. In addition, any active trade or business carried on directly by the foreign corporation in a less developed country will qualify for investments of earnings. Investments in an 80-percent-owned subsidiary qualify in the same way as investments in the foreign corporation's own trade or business, if the stock was owned continuously since December 31, 1962, or has been held for the 5 years preceding the taxable year in question.

In addition to investments in a controlled foreign corporation's own trade or business, qualified property also includes stock acquisitions in a subsidiary where the corporation and no more than four other U.S. persons own directly or indirectly more than 50 percent of the voting stock of the corporation and the investing corporation owns at least 10 percent. However, this type of investment will qualify only if the subsidiary is engaged in the active conduct of a trade or business almost wholly within a less developed country or countries and is organized under the laws of such a country. It was recognized, however, that in some cases the 50-percent test referred to above may be impossible to meet because the laws of the country involved do not permit foreigners to own so high a percentage of the voting stock of certain types, or all types, of local corporations. Where there are such laws the maximum ownership required, in lieu of the 50 percent, is to be whatever lower maximum is permitted by the laws of the specific foreign country involved.

Generally, property of the controlled foreign corporation cannot be located within the United States and still be qualified property.

[1] Since actual dividend distributions are treated as made first out of amounts taxed to shareholders as increases in earnings invested in nonqualified property, to the extent that actual distributions are treated as made out of this nonqualified property balance it is necessary to reduce the balance of nonqualified property as of the close of the prior year by the amount which now has been actually distributed. If this were not done it would be possible to retain the nonqualified investments in the corporation and make actual distributions out of other property to the shareholders which would not be taxable to them.

Certain exceptions, however, are made but these apply only where the property located within the United States is ordinary and necessary to the active conduct of the foreign corporation's business or substantially the same trade or business, and then only if the property represents—

(1) investments in U.S. bonds, money, or bank accounts,

(2) property purchased in the United States for export to, or use in, a foreign country, or

(3) loans arising in connection with the sale of property where the amount of the loan outstanding does not exceed the amount which would be ordinary and necessary in the trade or business of both the lending and borrowing corporation had the sale been between unrelated persons.

Generally, bringing earnings back to the United States is disallowed unless the shareholders have paid tax on these earnings. The exceptions noted above, however, are believed to be normal commercial transactions without any intention to permit the funds to remain in the United States indefinitely.

6. *Less developed countries.*—For both the foreign base company income provision in the subpart F income and also for purposes of the increase in earnings taxed to the shareholders in the case of investments in nonqualified property, investments are allowed as offsets if they are made in "less developed countries." Less developed countries under the bill are defined as foreign countries (other than areas within the Sino-Soviet bloc) or possessions of the United States where the President of the United States has designated such a country or possession as economically less developed.[2] However, the following countries are in no event to be considered as less developed countries:

Australia	Luxembourg
Austria	Monaco
Belgium	Netherlands
Canada	New Zealand
Denmark	Norway
France	Union of South Africa
Germany (Federal Republic)	San Marino
Hong Kong	Sweden
Italy	Switzerland
Japan	United Kingdom
Liechtenstein	

7. *Foreign tax credit.*—U.S. shareholders who are taxed on subpart F income, or on the increase of earnings invested in nonqualified property, can obtain a foreign tax credit for foreign income, etc., taxes paid by the foreign corporation, if the shareholder is a person to whom such a foreign credit would be allowed in the case of an actual distribution. That means that foreign tax credits will be allowed where the shareholder is a domestic corporation holding the stock of a foreign corporation and it has at least a 10-percent voting stock interest. Similarly, where a domestic corporation has at least a 10-percent interest in a foreign corporation which in turn has at least a 50-percent voting stock interest in a subsidiary, then a foreign tax credit

[2] Overseas territories, departments, provinces or possessions for this purpose may be treated as separate countries. Thus, even though the "home" country may be classified as developed, the oversea area may be considered less developed.

will be allowed the U.S. shareholder with respect to the earnings of this subsidiary when undistributed earnings of the subsidiary are taxed to the U.S. corporate shareholder. Taxes so allowed as credits will not again be allowed as credits when actual distributions are made.

Where the foreign country imposes a tax directly on dividend distributions, such a tax would not, of course, initially be taken into account when the shareholder at an earlier date was taxed on undistributed earnings of a controlled foreign corporation. These taxes on actual dividend payments, however, will be allowed as credits in the year in which the actual dividends are paid, even though these dividends are not taxable to the domestic corporation receiving them because of an earlier inclusion by it of these amounts in its income. Adjustments are made in the overall and per country limitations to keep these limitations from reducing the creditable taxes in such cases below what could be credited if the income taxed and taxes attributable to this income had been taken into account in the same year. Moreover, if the taxpayer has insufficient income against which to offset such credits in the year of the actual distribution, then refunds are allowed.

8. *Adjustments to basis of stock.*—It is necessary where amounts not actually distributed to the taxpayer are nevertheless taxed to him, to increase his basis for the stock in the controlled corporation by the amount so taxed to him. However, if subsequently actual distributions are made which do not result in any tax to the shareholder because of the prior tax payment by him, then the basis of the stock needs to again be reduced. The bill makes provision for these adjustments.

9. *Effective date.*—This provision applies to taxable years of foreign corporations beginning after December 31, 1962, and to taxable years of U.S. persons ending within or with these taxable years of the foreign corporations.

XV. GAIN FROM DISPOSITION OF DEPRECIABLE PERSONAL PROPERTY

(Sec. 14 of bill and secs. 1245, 167(f), 170(e) and 453(d) of code)

A. Reasons for provision

Under present law, in the case of depreciable property the taxpayer may write off the cost or other basis of the property over the period of the useful life of the asset in his hands. This cost or other basis can be written off evenly (or in a "straight line" over the asset's life), under the declining balance method, under the sum-of-the-year's digits method, or under any other consistent method which does not during the first two-thirds of the useful life of the property exceed the allowances which would have been allowed under the declining balance method. This depreciation deduction is a deduction against ordinary income. If either the useful life of the asset is too short, or the particular method of depreciation allows too much depreciation in the early years, the decline in value of the asset resulting from these depreciation deductions may exceed the actual decline of the value of the asset. Wherever the depreciation deductions reduce the basis of the property faster than the actual decline in its value, then when it is sold there will be a gain. Under present law this gain is taxed as a capital gain, even though the depreciation deductions reduced

ordinary income. The taxpayer who has taken excessive depreciation deductions and then sells an asset, therefore, has in effect converted ordinary income into a capital gain.

The President stated that our capital gains concept should not encompass this kind of income. He indicated that this inequity should be eliminated, especially in view of the proposed investment credit for newly acquired property. He states that we should not encourage the further acquisition of such property through tax incentives as long as this loophole remains. It is also desirable to amend the law to remove the tax advantage related to depreciation deductions in order to make it feasible for the Treasury to adopt more liberal rules with respect to the estimated useful life of depreciable assets.

Your committee in general is in accord with the President's point of view although it has made a number of modifications in the proposal he presented. Your committee's bill, as recommended, in general treats as ordinary income any gain on the sale or other disposition of certain depreciable property to the extent of the depreciation deductions taken. Under your committee's provision, however, this treatment will apply to property subject to the allowance for depreciation which is either (1) personal property or (2) certain other tangible property which does not include a building or its structural components. Your committee decided not to apply this treatment to buildings or structural components of buildings at this time because testimony before your committee indicated that this treatment presents problems where there is an appreciable rise in the value of real property attributable to a rise in the general price level over a long period.

Your committee also decided that this provision should have a clearly prospective application and, therefore, the only gain which is to be treated as ordinary income is depreciation occurring in 1962 and subsequent years.

Also, because of the assurance this provision provides of recapturing excessive deductions as ordinary income, your committee has found it possible to be more lenient in determining salvage value for depreciation purposes. Under your committee's provision, in determining depreciation the salvage value of an asset may be reduced by up to 10 percent of its cost or other basis, and if this value is less than 10 percent of basis (at the time it is determined), it may be disregarded altogether. In addition, for a period of time after the new ordinary income treatment becomes applicable, taxpayers will have a new election to change their method of depreciation with respect to personal property from any declining balance or sum of the years digits method to the straight-line method. This will enable them to elect a more conservative method of depreciation if they wish to escape the possibility of ordinary income upon the sale of the assets, because of excessive depreciation deductions.

The above description has been in terms of the sale or exchange of a depreciable asset. There are, of course, other methods of disposing of an asset which also must be dealt with in this provision. In the case of a gift or a transfer at death no gain is recognized at the time of the disposition of the asset. In the case of a gift, however, the ordinary income potential of the depreciation deductions carries over into the hands of the donee. In the case of gifts to charity, although no ordinary income is recognized at the time of the gift, the charitable

contribution is reduced by the amount which would be recognized as ordinary income if the property were sold. Generally, in other cases any gain which under present law would be recognized at the time of the disposition of an asset will be treated as ordinary income to the extent of any depreciation deductions taken. In certain cases, however, in order to prevent tax avoidance it has also been found necessary to realize ordinary income on the disposition of an asset even though gain might not otherwise be recognized. This is true in certain cases where a distribution is made by a corporation or partnership. These and other provisions where ordinary income may be recognized are described in the general explanation below.

B. General explanation of provision

1. General rule.—The general rule (in sec. 1245) provides that ordinary income is to be recognized in the case of sales or exchanges to the extent the so-called recomputed basis, or amount realized in the sale or exchange, whichever is lesser, exceeds the basis of the property in the hands of the person making the sale or exchange. "Recomputed basis" is defined generally as equaling the adjusted basis plus the depreciation deductions previously taken. The excess of the amount realized over the adjusted basis is, of course, the amount presently recognized as capital gain. Since the rule requires that the smaller of these two amounts be treated as ordinary income, this in effect means that the ordinary income in the usual case is to be the gain realized or the sum of the depreciation deductions taken, whichever is the smaller. Where there is a disposition of an asset without a sale or exchange, gain is determined by reference to the fair market value of the asset.

Since this provision is to have prospective application only, in computing depreciation for this purpose only depreciation deductions occurring in taxable years beginning after December 31, 1961, are to be taken into account. Depreciation deductions for this purpose include not only regular depreciation deductions but also the special initial allowance deduction and any deduction for the amortization of emergency facilities. The depreciation deductions taken into account are not limited to those taken by the taxpayer, but also include deductions taken by others from whom the taxpayer acquired the property, if the basis of the property was carried over from the person from whom the taxpayer acquired it. This would not be true, where the taxpayer acquired the property from another by reason of the latter's death, since in this case the property receives a new basis at death. The general rule is that the depreciation deduction taken into account for each year is the amount allowed or allowable whichever is greater. However, a special rule provides that the depreciation deductions taken into account as to any year will be the amount "allowed" rather than the amount "allowable" if the former is smaller and the taxpayer can establish what the amount was.

The type of property receiving the ordinary income treatment described above is (1) personal property (other than livestock) and (2) other property which is tangible, not including a building or its structural components, which is an integral part of certain specified business activities or which constitutes research or storage facilities used in connection with these activities. The activities specified are manufacturing, production, or extraction, or of furnishing transporta-

tion, communications, electrical energy, gas, water, or sewage disposal services. The exclusion for "livestock" means all types of livestock except poultry.

The ordinary income treatment provided by this section will be applied upon the sale of all property the acquisition of which could have resulted in an investment credit (sec. 38 of the code as added by this bill). However, the ordinary income treatment may also apply to the disposition of property even though the acquisition of this specific property did not result in an investment credit. For example, no investment credit may have been allowed upon the acquisition of the property because its expected useful life was less than 4 years, it was to be used outside of the United States, it was to be used by tax-exempt organizations or governmental units, it was not new when acquired (and was over the $50,000 limit), etc.

2. Exceptions.—Except as specifically provided in the bill, the ordinary income treatment applies any time property is disposed of. The bill, however, provides six general categories of exceptions to this rule. The first exception is for gifts. As pointed out above, however, these deductions must be taken into account by the donee, and may result in ordinary income to him, if he sells the property. In the case of depreciable property which is given to a charitable organization, although no income is realized by the donor at the time of the gift, the amount of the charitable contribution deduction he may receive is reduced by the amount which would have been treated as ordinary income had the property been sold at its fair market value (an amendment adding a new sec. 170(e)).

A second exception to the realization of ordinary income upon the disposition of depreciable personal property is provided in the case of transfers at death (except where the sale has occurred before death and the income is treated as income in respect to a decedent under sec. 691). In this case, however, there is not a carryover of the income potential in the depreciation deductions to the decedent's legatee or heir.

A third category of exceptions to the realization of ordinary income is provided in the case of a series of transactions which generally are tax free and in which the basis is carried over. However, in these transactions where there is any gain recognized, because the exchange is accompanied by "boot" (i.e., money or its equivalent) then to the extent of this gain, ordinary income may be realized (unless the depreciation deductions are smaller). The tax-free transactions referred to relate to those occurring upon the complete liquidation of a subsidiary (sec. 332); in the case of a transfer for stock or securities to a corporation controlled by the transferor (sec. 351); in the case of a transfer by a corporation which is a party to a reorganization of property in pursuance of a plan of a reorganization solely for stock or securities in another corporation also a party to the reorganization (sec. 361); and in the case of reorganizations in certain receivership and bankruptcy proceedings (sec. 371(a) and sec. 374). Also included in the same category are contributions of property to a partnership in exchange for an interest in the partnership, and distributions by a partnership in partial or complete liquidation of an interest (but in this respect see the special partnership treatment described below). Despite the above rule there would be a recognition of ordinary income where there is a contribution of depreciable property to a tax-

exempt organization (other than a tax-exempt farm cooperative) in exchange for stock or securities in the exempt organization. Recognition of ordinary income in this case is provided because a disposition of the property by the exempt organization would not ordinarily give rise to the realization of ordinary income with respect to the depreciation deductions.

Another exception is provided in the case of so-called like kind exchanges of property used for production or investment, and for involuntary conversions. In exchanges of these types, the ordinary income realized is limited to any gain recognized, plus the fair market value of property acquired in exchange for depreciable property where the latter is exchanged for nondepreciable property or other nonqualifying property. The realization of ordinary income (to the extent of the depreciation deductions) is necessary in such cases since in the case of property, other than depreciable personal property, there is no opportunity for subsequent recovery of the ordinary income element. A similar exception is provided in the case of the exchange or sale of property in obedience to Federal Communications Commission orders or orders of the Securities and Exchange Commission (secs. 1071 and 1081). In these cases also, the ordinary income realized is limited to the gain recognized, plus any unrecovered depreciation charges with respect to exchanges of depreciable personal property for other types of property.

Special rules are also provided in the case of distributions of depreciable personal property by a partnership to a partner. A distribution of depreciable personal property by a partnership to a partner to the extent that the distribution accounts for the partner's share of gain attributable to this property is not to result in ordinary income to the distributee partner at the time of the distribution. However, the ordinary income potential of depreciation deductions taken by the partnership (or by any earlier transferee from whom the partnership acquired property without realization of gain) will be carried over to the distributee partner. When he disposes of this property, the ordinary income potential of these partnership (or prepartnership) depreciation deductions will be taken into account in a manner substantially the same as that applying where the taxpayer himself took the depreciation deductions. The property distributed is given a "recomputed basis" to the partner equal to the basis of the property in the hands of the partner plus any ordinary income gain on which the partnership would have been taxed had the property been sold by it (at its fair market value) immediately before the distribution.

The rule described above applies only to the extent a partner is considered as receiving his share of the property representing ordinary income gain. An amendment made elsewhere to the code (sec. 751(c)) provides that in other cases the ordinary income element in depreciable property is to be considered as a "unrealized receivable." Thus to the extent of depreciation deductions taken (or potential gain if smaller) ordinary income will be realized in the case of the sale of a partnership interest, in the case of a distribution to a retiring or deceased partner, and in the case of distributions to a partner where he receives either more or less than his proportionate share of property reflecting this type of gain.

3. Dispositions resulting in ordinary income where no gain is presently recognized.—In a series of situations your committee found it necessary

to recognize ordinary income even though capital gain in such situations is not recognized under existing law. This was done primarily in those cases where the transferee receives another basis for the property than that of the transferor. This treatment is provided in three types of cases where a distribution is made by a corporation without the payment of a tax at the corporate level on unrealized appreciation in value: namely, where the property is distributed as a dividend (under sec. 311), where the property is distributed in a partial or complete liquidation by a corporation (sec. 336), and where in a plan of complete liquidation a corporation sells the depreciable personal property and perhaps other assets and within a 12-month period completes the liquidation of the corporation (sec. 337). Similarly, if the property is first sold by a corporation for installment notes and the gain which would be realized on such sale is delayed because of the installment method of reporting, a distribution of these notes to the shareholders in a liquidation under section 337 (12 months' liquidation) results in the recognition of the same amount of ordinary income to the corporation as would have been realized on a cash sale of such notes. The same rule is applied whenever similar installment notes are distributed by a corporation in a liquidation in which the basis of the property to the receiving shareholder is determined under section 334(b)(2) (purchase of 80 percent of the stock of one corporation by another followed by the immediate liquidation of the corporation acquired). The other situations where ordinary income may be realized under this provision, although capital gain would not otherwise occur, include the case where a distribution is made by a partnership and the partner gives up, or acquires, more than his proportionate share of this property. Other cases involve the provisions relating to the exchange of "like kind" property, involuntary conversions, sales or exchanges to effectuate FCC policy, and exchanges in obedience to orders of the FEC. In all of these cases where the property received in exchange for depreciable personal property is not itself depreciable personal property, then gain is recognized.

4. *Salvage value.*—The bill also amends the code (a new subsec. (f) in sec. 167) to provide that in computing the basis on which depreciation may be taken for personal property, salvage value may be ignored to the extent of an amount equal to 10 percent of the cost or other basis for the property. Thus, if the expected salvage value equals 8 percent of the basis of the property, the entire basis may be written off in depreciation charges by the taxpayer. If the expected salvage value is 12 percent, all but 2 percent of the basis of the property can be taken into account in computing depreciation charges. The provision applies to depreciable personal property (other than livestock) with a useful life of 3 years or more acquired after the date of enactment.

5. *Change in method of depreciation.*—Your committee recognized that some taxpayers who have been following liberal depreciation policies may desire to follow more conservative policies in order to avoid the possibility ordinary income treatment at time of sale as provided by the bill. Therefore, the bill provides that a taxpayer may elect to change his method of depreciation with respect to depreciable personal property from any declining balance or sum of the years digit method to the straight-line method. The right to make

this election will be available for a period to be specified by the Secretary of the Treasury, after the regulations on this provision have been issued.

6. *Effective date.*—This provision is to apply with respect to taxable years beginning after December 31, 1961, and ending after the date of enactment of this bill.

XVI. FOREIGN INVESTMENT COMPANIES

(Sec. 15 of the bill and secs. 1246 and 1247 of code)

A. Reasons for provision

For the small investor who desires to diversify his shareholdings through the use of domestic mutual funds, or regulated investment companies, present law provides that if a series of conditions are met, including the distribution of at least 90 percent of the earnings of the regulated investment company no tax is imposed on the investment company to the extent it distributes its earnings. Thus, if a domestic company distributes its income currently, present law provides for the imposition of a single, rather than a double, tax, and that one is imposed on the investor rather than the company.

Increasingly in recent years, however, some taxpayers have sought to avoid this tax by investing in foreign investment companies rather than domestic companies. Under present law a foreign investment company usually pays no U.S. income tax, since U.S. tax is imposed only on income derived from sources within the United States and such companies generally have no U.S. securities and, therefore, have no income from U.S. sources. The U.S. shareholders of one of these investment companies are likely to pay a U.S. tax with respect to such investments only when they sell the stock and then, of course, this gain is taxed as a capital gain rather than ordinary income. The U.S. shareholder would, of course, pay tax on any dividend income received from such a company, but most of these companies follow the announced policy of reinvesting all of their income in stocks or bonds in order to prevent the imposition of any such dividend tax by the United States.

The tax avoidance occurring in the case of these foreign investment companies is a matter with which your committee has been concerned for many years. For example, in November of 1956, in one of your committee's press releases, the tax treatment of these foreign investment companies was listed as a tax avoidance scheme needing attention. Since that time the seriousness of this problem has increased substantially. This also is a problem referred to by the President in his tax message last year. At that time the President stated:

> For some years now we have witnessed substantial outflows of capital from the United States into investment companies created abroad whose principal justification lies in the tax benefits which their method of operation produces. I recommend that these tax benefits be removed and that income derived through such foreign investment companies be treated in substantially the same way as income from domestic investment companies.

It was proposed by the administration that the preferential treatment for investments in these foreign investment companies be

eliminated by requiring U.S. shareholders in such companies to pay tax currently on their share of the income derived from the foreign investment company. The provisions included by your committee in this bill achieve much the same result but without attempting to look through the foreign corporation to the American shareholders.

Your committee's bill in general terms provides that American shareholders in these foreign investment companies, when they sell or redeem their stock, are to be taxed at ordinary income rates on their share of any earnings and profits accumulated in the foreign investment company since December 31, 1962, or since the date they acquired the stock, whichever occurred more recently. However, your committee's bill also provides that this treatment can be avoided at the election of the foreign investment company if it distributes 90 percent of its taxable income other than net long-term capital gains currently and if it informs the U.S. shareholders of their share of any net long-term capital gains. However, for this treatment to apply, the U.S. shareholders must also include in income their share of capital gains whether or not distributed. The distributions of ordinary income in this case, since they are actual distributions, would, of course, in any case be reported for tax purposes by the U.S. shareholders.

B. General explanation of provisions

As indicated above, the bill provides alternative tax treatment for shareholders of foreign investment companies. Unless an election is made to the contrary, ordinary income treatment, to a limited degree, is provided at the time an investor in a foreign investment company either sells his stock or it is redeemed. However, if the companies distribute most of their taxable income and the shareholders report capital gain, whether or not distributed, then at their election the ordinary income treatment at the time of the sale of the stock is not to apply. These two alternative provisions are discussed below.

1. *Ordinary income treatment on sale of stock.*—The bill provides that on the sale or exchange of stock in a foreign investment company after December 31, 1962, any gain realized is to be treated as ordinary income, rather than a capital gain, to the extent of the taxpayer's share of the company's earnings and profits accumulated in years beginning after December 31, 1962. For this purpose the taxpayer's share of these earnings and profits is limited to those attributable to his stock which have been accumulated during the period he has held the stock (excluding any earnings taxed to him when the company was a foreign personal holding company or a controlled foreign corporation). Had the company been a domestic company, distributing most or all of its earnings, these same earnings would have been taxable to him. Thus, this provision is not designed as a penalty tax, but merely to accord, to the extent practicable, the same tax treatment as that provided for domestic regulated investment companies.

To give assurances that this ordinary income will not escape tax where the shareholder holds the stock until death, the bill provides that the step-up in basis, or increase in value, which would otherwise occur at date of death is not to occur with respect to the amount which would be ordinary income to the decedent had he sold the stock just before death. Thus, when the estate, heir, or legatee sells the stock, the same amount (assuming the stock has not gone down in value) will still result in ordinary income and will be subject to U.S. tax at that time. However, the estate, heir, or legatee in such a case can treat

this as "income in respect of a decedent." Thus, in computing his ordinary income tax he will be allowed a deduction for any estate tax attributable to inclusion in the decedent's estate tax base of the amount taxed as ordinary income.

Without regard to this provision, where a shareholder sells or exchanges stock in one of these foreign investment companies after holding it for not more than 6 months, the gain is short-term capital gain. Since this type of gain is treated much like ordinary income for tax purposes, the bill provides that if stock in a foreign investment company is held for 6 months or less the provision is not to apply.

A foreign investment company, for purposes of this provision is defined as a foreign corporation, either registered under the Investment Company Act of 1940 as a management or unit investment trust, or any other corporation engaged primarily in the business of investing, reinvesting or trading in securities where more than 50 percent of the voting stock (and total value of all shares) is held directly or indirectly by U.S. persons. "United States persons," a definition added to the code by the foreign trust provision in this bill (sec. 9), means a citizen or resident of the United States, a domestic partnership, a domestic corporation, and a domestic estate or trust.

To prevent avoidance of this ordinary income tax treatment through the use of tax-free (or partially tax-free) exchanges in which stock in a foreign investment company is exchanged for other stock (in a tax-free incorporation or contribution to capital under sec. 351), the bill provides that the substituted stock in such a case (where its basis is determined by reference to the basis of stock in a foreign investment company) is to be treated substantially as if it were the foreign investment company stock. Thus, upon its sale, any gain to the extent of the appropriate share of the foreign investment company's earnings and profits during the period the substituted stock was held (plus the period in which the foreign investment company stock itself was held) is to be treated as ordinary income.

The bill also contains several other provisions similarly designed to prevent the avoidance of the ordinary income treatment through indirect ownership of the foreign investment company stock through certificates in a trust, through stock in a domestic corporation, or through a partnership. In this respect it is provided first that a share of stock in a domestic corporation or a trust certificate is to be treated as foreign investment company stock to the extent it represents such stock. Secondly, it is provided that if a company is a member of an affiliated group (with a 50-percent rather than an 80-percent stock-ownership requirement), then the earnings and profits of the entire group are to be allocated under regulations prescribed by the Treasury Department in a manner to carry out the purposes of the bill. Thus, where a foreign corporation is a holding company in the sense that it holds the stock of one or more foreign investment companies, the shareholders of the holding company will not be permitted to avoid ordinary income on the sale of the foreign holding company stock merely because the earnings and profits of the investment company (or companies) have not been distributed to the holding company. Thirdly, the bill provides that the ordinary income treatment is to apply to redemptions of stock by a foreign investment company which would otherwise be treated as sale transactions because of section 302(a)

(disproportionate buy-out of a shareholder) or because of section 303 (a redemption of stock to pay death taxes). Finally, the bill deals with the sale or exchange of and also certain distributions with respect to partnership interests. The bill provides that if any of the property of the partnership were stock in a foreign investment company and would have resulted in ordinary income had it been sold by the partnership itself, then this amount is to be treated as an inventory item. Thus, the sale of the partnership interest (and distributions in certain cases) will generally result in the incurring of ordinary income treatment with respect to the foreign investment company stock underlying the partnership interest.

The bill provides that the shareholder upon sale of the stock must establish the amount of the accumulated earnings and profits of the foreign investment company and his share of these earnings during the period of his investment. If he does not do so, the entire gain will be treated as ordinary income. This information, of course, is necessary to determine the amount subject to ordinary income tax. In addition, the bill provides that every U.S. person owning 5 percent or more in stock of a foreign investment company is to furnish with respect to such a company such information as the Secretary of the Treasury deems necessary in order to properly enforce the tax provisions applicable to shareholders of these companies.

2. *Election to distribute income currently.*—Foreign investment companies which are registered with the SEC to sell stock in this country can elect to make the provision described above inapplicable under certain conditions. Any such election must be made before December 31, 1962.

For the provision referred to above to be inapplicable the electing foreign investment company must agree with respect to the current and all subsequent years to—

(1) distribute 90 percent of its taxable income to its shareholders. This is exclusive of capital gains.[3] Also, such a corporation can elect to treat as distributed during the year distributions made in the first 2½ months after the end of the year.

(2) designate in written notices mailed to its shareholders their share of the excess of net long-term capital gains over net short-term capital losses, and the portion, if any, which the corporation has distributed. These notices must be mailed to the shareholders within 30 days after the close of the taxable year.

(3) provide such information as the Treasury Department considers necessary to carry out the purposes of this provision.

In addition to the corporation fulfilling these requirements, however, the individual shareholder (who is a U.S. person), if he is to avoid the ordinary income treatment upon the sale of his stock, also must include in his income for tax purposes the excess of the net long-term capital gain over the net short-term capital loss, which the company in its notice to him designated as being his share of the company's capital gains. If the shareholder does not do so for any year, unless this failure was due to reasonable cause and not to willful neglect, the election provided by this provision will not apply when he sells or otherwise disposes of his stock. Thus, although other shareholders

[3] For this purpose, as in the case of domestic regulated investment companies, no net operating loss carryover is allowed and no organizational expense deduction is allowed.

might continue to qualify in such a case, the shareholder who did not report this capital gain income, upon his sale of the stock will have ordinary income (limited as indicated above). It is not made a condition of qualification that the shareholder in such a case report his share of the ordinary income of the corporation. However, since at least 90 percent of his share of this income will actually be distributed to him, it must in fact be reported by him, in the same manner as any other dividend income which he may receive from foreign sources.

The bill provides that these capital gains, reported by the shareholders, although not actually distributed, are to result in a decrease in earnings and profits of the corporation for the shareholders who report them and also that the basis that they had for the foreign investment company stock is to be increased by this amount.

The election described above with respect to the foreign investment company continues until the company fails to comply with the three conditions set forth above, unless the company becomes a foreign personal holding company, or no longer is a foreign investment company.

To prevent the use of the capital gains designating provision as a means of obtaining short-term capital losses which may be short-term capital gains or under certain circumstances ordinary income, merely at the cost or reporting a capital gain under this provision, the bill provides that if the shareholder has held the stock for less than 6 months, then any loss realized on the sale of the stock within that 6-month period is to be treated as if it were a long-term rather than short-term capital loss.

3. *Effective date.*—The amendments made by this provision apply to taxable years beginning after December 31, 1962.

XVII. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS

(Sec. 16 of bill and sec. 1248 of code)

A. Reasons for provision

Under existing law, through an ordinary taxable liquidation or sale or exchange, it is possible to bring earnings accumulated by a foreign corporation back to this country merely by paying a capital gains tax on any gain. Theoretically it is also possible to bring earnings accumulated by a foreign corporation back to the United States without payment of income tax through the use of a tax-free reorganization (under sec. 368) or through the use of a tax-free liquidation (under sec. 332). However, to do so the Commissioner of Internal Revenue must give clearance by determining in advance that the transaction "is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes." Generally the Commissioner has been unwilling to grant such approval where there is an appreciable amount of earnings and profits accumulated in a foreign corporation.

Your committee has as one of its objectives in the foreign income area the imposition of the full U.S. tax when income earned abroad is repatriated. These objectives are set forth more fully in connection with the discussion on controlled foreign corporations in section 13 of the bill. Full U.S. taxation will occur in the case of the ordinary,

taxable liquidations or sales or exchanges only if the earnings and profits are in effect taxed as dividends (to the extent of any gain) at the time the funds are brought back to the United States. This objective is accomplished by this section of your committee's bill.

B. General explanation of provision

The new provision contains special provisions dealing with redemptions and liquidations, as well as with sales and other exchanges of certain stock of controlled foreign corporations (as defined in sec. 13 on controlled foreign corporations). These apply if the foreign corporation, the stock of which is sold or exchanged, was a controlled foreign corporation at any time during the 5-year period ending on the date of the sale or exchange. However, they apply only to any U.S. person who owned 10 percent or more of the total combined voting power of the foreign corporation at any time during the 5-year period ending on the date of the sale or exchange. (In computing the 10-percent ownership test, the ownership rules applicable in the case of controlled foreign corporations are used.)

The bill provides that if a controlled foreign corporation redeems its stock, and if the redemption is not already a dividend (under sec. 302), then the gain to the stockholder from the exchange of his stock is to be treated as a dividend to the extent of his share of the earnings and profits of the foreign corporation. This provision applies in the case of a partial liquidation, a total liquidation or a buy-out of all of a shareholder's stock. If the shareholder is a domestic corporation, the foreign tax credit is allowed in the same manner as in the case of dividends generally.

In the case of a sale or exchange of stock of a controlled foreign corporation by a shareholder, the gain of the seller is considered by the bill to be ordinary income to the extent of his share of the earnings and profits of the foreign corporation accumulated during the period he held the stock.

The operation of the above two provisions may be illustrated by the following examples. Assume a U.S. corporation owns all of the stock of a foreign corporation and that the foreign subsidiary is liquidated. Assume further that the transaction is a taxable one because the commissioner refused to grant clearance under section 367. Under the bill this liquidation remains a taxable one. However, while under existing law all of the gain recognized to the domestic corporation probably would be capital gain, under the bill the domestic corporation is viewed as having received a dividend, to the extent of the earnings and profits of the foreign corporation at the time of the liquidation, or to the extent of the gain recognized, if that is smaller. Thus, if the basis of all of the subsidiary's stock is $100,000 and the fair market value of all of the assets received by the parent on the liquidation is $200,000, the gain which would be recognized under present law is $100,000. If the foreign subsidiary had current and accumulated earnings and profits of $50,000 at the time of the liquidation, under the bill the parent is treated as having received a dividend of $50,000 and a capital gain of $50,000. Any credit for foreign taxes paid would apply to the amount treated as a dividend in the same manner as in the case of an actual dividend of $50,000.

In a second example, assume a domestic corporation proposes to acquire substantially all of the assets of a foreign corporation, solely

for voting stock of the domestic corporation. Immediately after this acquisition the foreign corporation is to be liquidated and its shareholders given stock of the domestic corporation in exchange for their stock in the foreign corporation. Assume also that clearance under section 367 is requested from the Commissioner and denied. The acquisition of the assets of the foreign corporation for the stock of the domestic one is not a tax-free acquisition (under sec. 368). Also, the distribution of stock of the domestic corporation to the shareholders of the foreign corporation is an ordinary taxable liquidation. Under the bill if any shareholder owned more than 10 percent of the stock of the foreign corporation during the preceding 5 years, and if the foreign corporation was a controlled foreign corporation at any time during that period, the provisions of the bill are to apply to such a shareholder. Thus, the shareholder will be treated as having received a dividend to the extent of the accumulated earnings and profits of the foreign corporation at the time of the liquidation or to the extent of his gain, whichever is smaller.

The section does not apply to redemptions to pay death taxes (sec. 303) nor does it apply to gain recognized because of boot on reorganization exchanges (sec. 356).

The section also does not apply to the extent that any amount of gain is under other code provisions treated as a dividend, a gain from the sale of an asset which is not a capital asset, or a gain from the sale of an asset held for not more than 6 months.

The bill provides that if there are any earnings and profits accumulated and not distributed which have already been included in gross income (under the controlled foreign corporation provision as added by sec. 13 of the bill) the amount which has been so included is not to be included in the same shareholder's income a second time.

The limitations described above on the amount to be treated as dividend or ordinary income are not to apply unless the taxpayer establishes the earnings and profits of the foreign corporation to be taken into account. If this is not established, any gain from a sale, exchange or redemption is to be considered a dividend, or ordinary income, as the case may be.

The section is made effective with respect to sales or exchanges occurring after the date of enactment of the bill.

XVIII. TAX TREATMENT OF COOPERATIVES AND PATRONS

(Sec. 17 of the bill and secs. 1381 to 1388 of the code)

A. Reasons for provision

In 1951 Congress passed legislation which, taken together with prior Treasury rulings, it generally was thought insured that earnings of cooperatives would be current taxable (to the extent they reflected business activity) either to the cooperatives or to the patrons. However, certain court decisions, notably, the *Long Poultry Farm* and *B. A. Carpenter* cases, held that noncash allocations of patronage dividends generally were not taxable to the patron, although they were deductible by the cooperative.

The President recommended that what was thought to be the law in 1951 be provided specifically in the statute. Under the recommendation cooperatives would be allowed to deduct amounts allocated

in cash or scrip as patronage dividends and patrons would be currently taxable on the patronage dividends allocated to them arising out of business activities.

Your committee's bill adopts an approach which in substance is substantially the same as that recommended by the President. It provides that the cooperative is not required to take patronage dividends paid in money, qualified allocations, or other property except the nonqualified allocations into account in determining taxable income. A deduction is also provided for the nonqualified allocations when they are redeemed. For the patron, the bill provides that these same amounts (to the extent not attributable to purchases of personal living or family items) are to be included in their income for tax purposes in the year received (or in the case of a nonqualified allocation, when redeemed).

Qualified allocations for this purpose are defined by the bill as including first, allocations which the patron can redeem in cash at their stated dollar amount at any time in the first 90 days after they are issued. Second, qualified allocations also include allocations which the patron has consented to take into account at their face amount as income (unless the patronage was with respect to personal living expenses or capital items). In the case of members, consent may be given by being a member of the cooperative if there is a provision in the bylaws requiring all members to agree to take the allocations into account. In the case of nonmembers (and members if the cooperative prefers) this consent can be provided by the patron signing an agreement to do so. Your committee believed that, since in the case of either the 90-day or consent allocation the patrons have constructively received the dividend and reinvested it, it is clear (where the patronage dividend arises from business activity) that it constitutes income to the patron and is properly taxable to him.

This amendment is effective for taxable years beginning after December 31, 1962, in the case of the cooperatives and in the case of patrons is effective with respect to amounts paid by the cooperatives in taxable years of the cooperative beginning after that date. Existing law will continue to apply with respect to allocations (including their redemption after the specified date) issued in earlier taxable years to which the new provisions do not apply.

B. General explanation of provision

This provision deals both with the tax treatment of cooperatives and the tax treatment of patrons.

1. Cooperatives covered by provision.—The tax treatment outlined here applies to the so-called tax-exempt farmers' cooperatives, to other farm cooperatives, to consumer cooperatives, and also to other corporations operating on a cooperative basis. The provision does not, however, apply to exempt mutual ditch, irrigation, or REA cooperatives, to mutual savings banks, building and loan associations, etc., or to mutual insurance companies. It also does not apply to presently taxable organizations which are engaged in furnishing electric energy, or providing telephone service, to persons in rural areas. These will continue to be treated the same as under present law.

2. Patronage dividends.—The bill provides that in determining the taxable income of a cooperative there is not to be taken into account patronage dividends which are paid in money, qualified allocations,

or other property (except nonqualified allocations).[4] A deduction also is allowed for nonqualified allocations when they are redeemed in cash or other property (except allocations). If there is no taxable income in the year of the redemption against which to take this deduction for redeemed nonqualified allocations, the cooperative may obtain a credit or refund of the tax it paid in the prior year on the earnings represented by the allocations. This gives the cooperative assurance that the deduction for the redeemed patronage dividend will not be wasted.

Under present law patronage dividends paid by taxable cooperatives result in a reduction in the cooperative's taxable income only with respect to amounts paid during the taxable year in which the patronage occurred, or within the period in the next year elapsing before the prior year's income tax return is required to be filed (including any extensions of time granted). This is generally a 2½-month period. In the case of exempt farmers' cooperatives, these patronage dividends presently are taken into account as a reduction in taxable income if paid at any time before the 15th day of the 9th month following the close of the year, but there is no requirement that the patronage must have occurred in that year. Your committee's bill extends the time period in which taxable cooperatives can pay patronage dividends, and still take them into account in reducing taxable income, until this 15th day of the 9th month after the end of the year in question. This conforms the treatment already accorded exempt cooperatives. This period of time is also made available to both "taxable" and "exempt" cooperatives for payment of the other deductible amounts described below. In addition, exempt cooperatives are now required to pay the patronage dividends within 8½ months after the year when the patronage occurred. In the case of pooling arrangements extending over more than 1 year, the patronage is considered as occurring in the year in which the pool closes.

3. *Qualified allocation.*—Allocations, or more exactly written notices of allocation, are patronage dividends paid in the form of capital stock, revolving fund certificates, certificates of indebtedness, or other written notice which indicates to the recipient the dollar amount allocated to him by the cooperative. For the allocation to be a qualified allocation (and therefore taken into account as a reduction in income for the year it is issued rather than the year it is redeemed) one of two conditions must be met. First, it may be an allocation where the patron for a 90-day period beginning with the date the allocation is paid has the opportunity to redeem the allocation in cash for the stated amount of the patronage dividend. However, for such an allocation to be qualified, the patron must receive a written notice of this right to redemption at the same time he is notified of the allocation.

The second alternative qualifying rule provides that the allocation is qualified where the patron gives consent to have it treated as a distribution to him which he will take into his income for tax purposes (if the patronage arises from a business activity). This consent may take either of two forms. For members of the cooperative this consent may be given by becoming or continuing as a member after the cooperative has adopted a provision in the bylaws providing that membership in the cooperative constitutes such consent. In this case,

[4] For purposes of the other internal revenue laws these patronage dividends are treated in the same manner as items of gross income for which deductions were allowed.

however, the member (or prospective member) must be furnished a written notice that the bylaws contain such a provision and must be furnished a copy of this provision. Such a consent cannot be revoked as long as the patron is a member. An alternative form of consent for members of the cooperative, and the only form of consent for nonmembers, is a written statement signed by the patron in which he gives the consent referred to above. This form of the consent must originally be given by the patron to the cooperative before the end of the year in which the patronage occurs. Once this consent is given it is valid for all subsequent years until the patron revokes it. A revocation becomes effective for the first of the next year (in the case of pooling arrangements it is effective only with respect to new pools). By either of these forms of consent the patron has in effect constructively received the patronage dividend and reinvested it in the cooperative.

4. Additional deduction for "exempt" farmers' cooperative.—In addition to reducing taxable income for qualifying patronage dividends, the bill permits the so-called exempt farmers' cooperative as under present law a deduction for amounts paid out as dividends on its capital stock. Such cooperatives also receive deductions for amounts paid in money, qualified allocations, or other property (except nonqualified allocations) to its patrons on a patronage basis where the earnings involved are derived from business done for the U.S. Government or from sources other than patronage (such as investment income).

This deduction, except that in the case of allocations it is limited to qualified allocations, is the same as that provided by existing law except that under your committee's bill, the amounts must now be paid within 8½ months after the year in which the earnings were *derived*. Amounts paid in the redemption of nonqualified allocations also are available to these exempt cooperatives as deductions under the bill.

5. Treatment of patron.—With the exceptions referred to below, under the bill the patron is required to take into income the patronage dividends (and the nonpatronage distributions described above) paid in money, qualified allocations, or other property and the amount he is required to take into his income is the same as that which may be currently deductible to the cooperative; namely, in the case of qualified allocations, their stated face amount and in the case of other property (except nonqualified allocations), its fair market value. The patron also is required to take into income any nonqualified allocations which are redeemed. These amounts are taken into the patron's income in the year in which they are received by him, or in the latter case in the year in which the redemption occurs.

Generally, the effect of the treatment specified above for patrons taken together with that also outlined above for cooperatives, is to obtain a single current tax with respect to the income of the cooperative, either at the level of the cooperative or at the level of the patron. However, this rule will not apply in the case of patronage dividends paid with respect to purchases of personal, living, or family items. In such cases, there is to be no inclusion in the income of the patron with respect to the patronage dividends. This is in accord with the concept that patronage dividends to the extent they are paid in money, qualified allocations, or other property (other than nonqualified

allocations) represent price adjustments. Therefore, the patronage dividends in these cases represent downward price adjustments of personal, living, or family items and should no more lead to taxable income than bargain purchases of such items elsewhere.

An exception to the rule for inclusion of the patronage dividends in income is also made for patronage dividends attributable to purchases of depreciable property or capital assets. In such cases the patron is not required to take the dividend into income since it in effect represents an adjustment in the price paid for these articles and therefore is reflected in their basis. However, the lower basis for the property in the case of depreciable property will mean smaller depreciation deductions or in the case of capital assets (and depreciable assets) will result in a larger gain upon sale.

6. *Returns of cooperatives.*—Because tax-exempt cooperatives under present law are given until 8½ months after the end of the year to allocate, or pay, patronage dividends, they also have been given the same period of time in which to file their tax returns. This additional time is necessary since whether or not there is an allocation or payment of the dividends, determines the size of the taxable income of the cooperative.

Allowing taxable cooperatives this same time in which to make cash and qualified allocations of patronage dividend distributions, and to redeem nonqualified allocations, has presented the same filing problem in the case of their returns as well. Therefore, the bill provides that the tax return filing date for cooperatives generally is to be 8½ months after the end of their taxable year. However, to prevent an organization allocating relatively little of its income on a patronage basis from obtaining this postponement in the filing date for its return, the bill limits this postponement to those organizations which are either exempt cooperatives or (1) are under an obligation to allocate, or pay, at least 50 percent of their net patronage earnings in patronage dividents or (2) actually allocated, or paid, at least that percentage of their earnings in patronage dividends during the last year in which they had any such earnings.

A second change made in the case of returns of cooperatives relates to information returns. Present law requires the Treasury Department to obtain information returns from cooperatives at least with respect to patronage dividends of $100 or more. With a system of withholding on patronage dividends, as is provided by section 19 of this bill, it is no longer clear that it is necessary to retain the $100 floor. In view of this, the bill amends the information return provision (sec. 6044) to permit the Treasury Department to raise this floor or completely remove any return requirements.

7. *Effective date.*—Generally, the bill applies to taxable years of the cooperatives beginning after December 31, 1962. For the patrons these provisions are to apply with respect to amounts received from a cooperative if the amount which is paid by the cooperative occurs with respect to patronage which at the cooperative level is also subject to the new rules. Existing law continues to apply with respect to patronage dividends paid before the date specified above (or after that date with respect to patronage in a prior year) and also with respect to redemptions of patronage dividends after that date if the scrip involved was actually issued with respect to an earlier period.

XIX. INCLUSION OF FOREIGN REAL PROPERTY IN BASE FOR ESTATE TAX PURPOSES

(Sec. 18 of bill and secs. 2031, 2033–2038, 2040 and 2041 of the code)

A. Reasons for provision

Under present law real estate situated outside of the United States is excluded from the gross estate and therefore exempt from the estate tax. This is an exception to the general rule that the gross estate of decedents who are citizens or residents of the United States include their entire property wherever situated. The exclusion of real property located outside of the United States from the estate tax base has been specifically provided for in the code since 1934. Before that time the exclusion was granted under an opinion of the Attorney General issued in 1918. No such exclusion exists under the gift tax.

In 1951 Congress adopted legislation providing a credit for estate and inheritance taxes paid to foreign countries. Before that time the exclusion of real property from the estate tax base could be justified on the grounds that the foreign country was likely to impose a tax on real property located within its jurisdiction upon the death of a foreign owner. However, with the provision for the tax credit in 1951, reducing the possibility of double taxation, the exclusion of foreign real property no longer appears appropriate.

The President in his tax program recommended that this exemption be eliminated on the grounds that in recent years this has been a subject of abuse. It was stated that primarily because of this tax advantage, U.S. citizens and residents have been induced to make investments in foreign real estate in countries with either no, or very low estate or inheritance tax rates.

In view of these considerations your committee has adopted a provision eliminating the exclusion of real property located outside of the United States from the estate tax base.

B. General explanation of provision

Under present law, real property situated outside the United States is excluded in determining the value of a decedent's gross estate for estate tax purposes. This section of the bill amends various sections of the code specifically to include such real property in the gross estate of decedents who are citizens or residents of the United States. The property is included at its fair market value either at the date of death or at the optional valuation date.

In the case of decedents dying after July 1, 1964, the bill provides that all real property located outside of the United States is to be included in their gross estate. However, some real property may also be included in a decedent's gross estate under the bill in the case of those who die after the date of enactment of the bill but before July 1, 1964. For decedents dying in this period, real property located outside of the United States is to be included in their gross estate if it was acquired on or after February 1, 1962, the date your committee announced its action on this provision. Thus, for those already owning real property outside of the United States before action was taken on this matter by your committee, time is provided for the orderly disposition of the property, or for rearrangement of estate plans—namely, until July 1, 1964—without imposing any estate tax consequences. However, your committee did not believe it appro-

priate to provide any similar grace period for those who acquired foreign real estate after the announcement of your committee's decision.

Capital additions or improvements to real property, to the extent they materially increase the value of the property and to the extent they are attributable to construction, reconstruction or erection on or after February 1, 1962, are treated in the same manner as real property acquired after that date. Thus, they are included in the gross estates of decedents dying after the date of enactment of the bill even though dying before July 1, 1964.

XX. WITHHOLDING OF INCOME TAX ON INTEREST, DIVIDENDS, AND PATRONAGE DIVIDENDS

(Sec. 19 of the bill and secs. 3451–3490 and sec. 39 of the code)

A. Reasons for provision

About $15 billion in dividends and interest were reported by individuals on tax returns in 1959, the latest year for which complete Treasury data are available. In addition, there were about $3.7 billion in dividends and interest that should have been reported in that year but were not. Most of this amount was subject to tax and the Treasury Department estimates that this underreporting resulted in a revenue loss of about $800 million in taxes for the year. Withholding will result in the collection of about $650 million of this amount and it is believed that almost all of the remaining gap will be accounted for when the automatic data processing system is fully developed. Your committee believes this provision also will make a real contribution toward the collection of the remaining $150 million of uncollected tax on dividends and interest.

Not only is the revenue loss in this case of major importance, but as the President pointed out in his tax message to Congress last year with respect to this underreporting:

> This is patently unfair to those who must, as a result, bear a larger share of the tax burden. Recipients of dividends and interest should pay their tax no less than those who receive wage and salary income, and the tax should be paid just as promptly. Large continued avoidance of tax on the part of some has a steadily demoralizing effect on the compliance of others.

Although educational programs have been used in attempting to cut down this underreporting there is no evidence that these programs have had any appreciable effect, nor can it properly be said that automatic data processing, even when fully developed several years from now, will be an adequate substitute for withholding. As indicated to your committee by the Treasury Department and Internal Revenue Service, withholding and ADP are designed to complement each other. Withholding collects the tax in the first bracket where the amount of underreporting per case are small, but, because of the large number involved, add up to a large proportion of the $850 million gap. Withholding in this area eliminates the necessity of using auditors or correspondence to actually collect these small amounts, while even where the ADP system would be successful in tracing them down a collection

effort still would be necessary to collect these small amounts. Secondly, withholding makes it unnecessary to drastically lower information return requirements with respect to interest and third, it frees ADP for more intensive use in examining returns above the first bracket where, per case, the underreporting, not only in the case of dividends and interest but in the case of other income as well, is substantially greater. The Treasury Department has estimated that while ADP would result in the collection of $200 million additional revenue in the case of dividends and interest at an administrative cost of $27 million, withholding will result in a revenue increase of $650 million at only an administrative cost of $19 million.

The system of withholding provided by your committee while, of course, it does not completely eliminate administrative problems for dividends and interest recipients and payors nevertheless is designed to minimize these problems, particularly in the case of the recipients.

First, in the case of recipients—

(1) An exemption system in the case of dividends, most forms of interest and patronage dividends means that there would be no withholding for individuals owing no income tax.

(2) In the case of individuals where the withholding is large relative to the tax liability, quarterly refunds which can be obtained during the year give assurance that even these taxpayers will not be out-of-pocket the overwithheld money any appreciable period of time. Moreover, the system is designed to minimize the paperwork for them.

(3) Permitting corporations to claim credits for the tax withheld on them against their withholding on their own dividend or bond interest payments, plus permitting them on a quarterly basis to obtain refunds of any excess should eliminate almost all effects of withholding in their cases.

(4) In the case of tax-exempt organizations and governmental units, permitting the claiming of credits for tax withheld on them against the withholding they already perform on wage and salary payments to their own employees, plus exemptions or exemption certificates in certain cases, plus the provision for quarterly refunds should eliminate or minimize any withholding effects in their cases.

Second, by providing for withholding at a uniform 20 percent without any requirements for supplying receipts should ease problems both for the payors and the recipients. The even 20-percent rate will minimize problems with fractions in dividend and interest computations and make it easy for the individual to include in his return, and claim credit for, the amount withheld, merely by increasing the 80 percent remaining after withholding by 25 percent.

Third, the retention of a uniform withholding rate applicable in all cases, except where the exemption certificates are filed, should hold to a minimum the actual administrative problems of the payors since they will be able to send a single check to the Government equal to 20 percent of their gross dividend or interest payments (apart from those with respect to which exemption certificates were filed).

Fourth, dividend and interest payors are compensated for any additional administrative costs they may have by being permitted to retain the use of the withheld amounts of tax until 1 month after the end of the quarter of their taxable year to which the interest relates.

B. General explanation of provisions

The bill provides that payors of interest, dividends, and patronage dividends are to withhold one-fifth or 20 percent of the payment they would otherwise make to the interest, dividend, or patronage dividend recipient, with certain exceptions noted above. This withheld amount is to be paid over to the Government by the payor (sec. 3481) by the last day of the first month after the end of each quarter of the payor's taxable year (April 30, July 31, October 31, and January 31 for calendar year taxpayers).

The recipient of the interest, dividend, or patronage dividend payment when he files his own income tax return can claim credit for the payment made by the payor on his behalf. This withholding system does not require the attachment of any receipt by the recipient of the payment to his tax return (sec. 3489 provides a presumption that amounts have been withheld). It also does not require the payor to send the income recipient any receipt. Instead, it is presumed that, initially at least, payors will indicate in some communication to the recipient of the payment that the payment is "net," that is, reduced by one-fifth for the amount withheld for the Government.

It is contemplated that the recipient of the payment on his tax return first will report the net interest, dividend, or patronage dividend payment received. He will then be requested to add to this amount one-fourth of the amount received, representing the amount withheld. This is what is referred to as "grossing up" the interest or dividend payment. Thus, for example, if an individual were entitled to $100 of dividends before withholding, one-fifth of this amount, or $20 would be withheld by the payor and remitted to the Government. The remaining $80 would be the net dividend payment received by the recipient. This is the amount he would initially report on his income tax return. He would be asked to add to this one-fourth of this amount, or $20, bringing the total back to the full $100 dividend payment. He would then compute his income tax in the usual manner. Finally, the tax otherwise owed would be reduced by the amount withheld with respect to this dividend payment, namely, $20.

Under the bill, provision is made for exemptions from withholding in certain cases and also for quick refunds where no tax is owed or there is overwithholding. In addition, no withholding is provided in the case of certain types of interest and other payments.

The withholding provisions generally are to be effective with respect to interest and dividend payments made after January 1, 1963. In the case of patronage dividends, the withholding provisions will apply to payments with respect to patronage occurring in the first taxable year of the cooperative beginning after January 1, 1963.

1. General definitions of interest, dividends and patronage dividends.—The bill defines interest, dividends, and patronage dividends, to which withholding is to apply, in fairly broad terms and then specifies certain exceptions. The definitions are described here; the discussion of the exceptions then follows.

The definition of interest provided by the bill for the most part is limited to payments made by corporations where the holder of the indebtedness is likely to be an individual (although not necessarily actually so in any given case). In addition, where non-interest-bearing obligations are issued on a discount basis, no attempt is made to withhold on the payments received at the time of the redemption

of the obligation (except in the case of savings bonds). Withholding is not provided where discounts are involved because of differences in the tax treatment of original issue discount where the obligation is held to maturity by the initial holder and where it is acquired before that time by a subsequent purchaser.

In more specific terms, the bill includes within the definition of interest, to which withholding is applied, seven different categories of interest:

(1) Interest on evidences of indebtedness (such as bonds, debentures, notes, and certificates) issued by a corporation with interest coupons or in registered form. In addition, there is included interest on other types of indebtedness issued by a corporation where the instrument is of a type generally offered by corporations to the public, but only to the extent so provided by regulations issued by the Treasury Department. This will not include interest on mortgage paper generally, since mortgages usually are not of a type offered by corporations to the public.

(2) Bank account interest.

(3) So-called dividend payments made by mutual savings banks, savings and loan associations, building and loan associations, cooperative banks, homestead associations, credit unions, etc.

(4) Interest on amounts held by insurance companies under an agreement to pay interest. This does not include policyholder dividends but does include interest on accumulations of such dividends as well as other amounts held at interest by these companies. The withholding occurs at the time the amounts otherwise are required by law to be reported as income.

(5) Interest on deposits with stockbrokers.

(6) Interest on obligations of the United States. This does not include any obligations issued at a discount, such as Treasury bills (but see category 7 below).

(7) Interest on non-interest-bearing obligations of the United States issued at a discount and having a maturity of more than 1 year from the date of issue. This is primarily interest on series E savings bonds.

The definition of a dividend for purposes of the withholding tax is the same as that provided by the code for other purposes (as defined in sec. 316). However, in addition, "dividends" are defined as including payments made by stockbrokers as substitutes for dividends. Thus, if an individual has sold stock short, his broker may have borrowed stock for him from another person to cover his short sale. If a dividend becomes payable during the period of the loan of the stock, in such a case the stockbroker must make a payment to the person from whom the stock was borrowed as a substitute for the dividend he would otherwise receive (and obtain reimbursement for this payment from the person to whom the loan of the stock was made). Under the bill such a substitute payment by a stockbroker is treated as if it were a dividend for purposes of withholding.

In the case of patronage dividends withholding will apply to those paid in money, in qualified allocations, and in other property except nonqualified allocations. (See XVIII–B–3 for discussion of qualified allocations.) In addition, in the case of the so-called exempt farmer's cooperative, withholding is to apply to amounts not representing

patronage dividends where the amounts are paid to patrons in money, qualified allocations, or other property (except nonqualified allocations) if the payment is made on a patronage basis and the earnings involved are derived from business done with the United States or from sources other than patronage (such as investment income). Withholding does not, however, apply to so-called progress payments made by marketing cooperatives.

2. General exceptions where withholding does not apply.—The bill provides certain exceptions to the definitions of interest, dividends and patronage dividends subject to withholding. In the case of all three categories of payments the bill provides that no withholding is to occur with respect to amounts paid by one corporation to another where both are members of the same affiliated group and where a consolidated return was filed for income tax purposes in the past year. In such cases these intercompany transactions are "washed out" for tax purposes.

A second group of payments to which withholding is not to apply in the case of any of these three types of payments are those made to nonresident aliens and foreign corporations where there already is a special form of withholding by the payor under present law, or where there would be but for the fact that the income is not considered as income from sources within the United States.

A third group of payments to which withholding will not apply are interest, dividend, or patronage dividends paid by foreign corporations not engaged in trade or business within the United States. The corporation in such cases is not subject to U.S. jurisdiction although income received from it by a U.S. citizen or resident may be subject to U.S. tax.

In the case of interest payments, exemptions from withholding are also provided for—

(1) Interest on tax-exempt State and local obligations since these are not subject to income tax.

(2) Amounts paid by a foreign government, international organization, nonresident alien not engaged in a trade or business here, or a partnership not engaged in a trade or business here and composed in whole or in part of nonresident aliens. (An exemption for foreign corporations not in business here was previously noted.) In such cases the payor is not subject to U.S. jurisdiction although income received from it may be subject to U.S. tax in the hands of a U.S. citizen or resident.

(3) Bank account interest paid to foreign corporations, nonresident aliens, and foreign partnerships. In this case the income is not subject to U.S. tax.

(4) Amounts paid with respect to tax-free covenant bonds. The payor in such a case is required to pay the tax.

(5) Amounts paid with respect to deposits in school savings accounts to the extent provided by regulations. In such cases the exemption in general will be limited to children, the great bulk of whom would in any case owe no income tax.

(6) Bank account, mutual thrift and Government series E bond interest paid to States, foreign governments, and international organizations. In these cases the interest income is not subject to tax by the United States.

(7) Amounts paid by a U.S. agency or instrumentality to another U.S. agency or instrumentality if the Secretary of the Treasury determines that the withholding in this case represents an unnecessary burden. In this case also no tax would be due.

In the case of dividends, the additional exceptions where withholding is not to apply are as follows:

(1) Amounts paid in stock or stock rights where the distribution is not includible in the income of the recipient.

(2) Any distribution where the recipient treats the amount received as a capital gain or recognizes no gain or loss.

(3) Amounts which, even though includible in the income of the recipient, are treated as redemptions of stock (sec. 302), dispositions of section 306 stock, additional consideration in connection with certain reorganizations (sec. 356), or distributions pursuant to an SEC order (sec. 1081(e)(2)).

(4) Undistributed amounts treated as dividends of corporations electing subchapter S treatment (treatment similar to partnerships).

(5) Amounts paid under a lease entered into before 1954 where the shareholders of the lessor corporation are entitled to the amounts without deduction for any U.S. tax.

In the case of patronage dividends, in addition to the exceptions previously noted, where the Secretary of the Treasury determines that a cooperative is primarily engaged in selling at retail goods or services which are generally for personal, living, or family use, an exemption from withholding may be provided. Patronage dividends in this case are not includible in the income of the recipient and, therefore, need not be subject to withholding.

3. Exemption certificates and intra-annual refunds and credits for individuals.—To prevent hardships in the case of those who owe no tax on their interest, dividends, or patronage dividend payments, or who are subject to overwithholding, the bill contains a series of provisions providing for exemption from withholding or refunds or credits of the withholding tax. Under this heading there are presented those provisions applicable in the case of individuals. This is followed by discussions of the provisions applicable to governmental units and tax-exempt organizations, to corporations generally, and finally to nonresident aliens.

In the case of individuals, interest, dividend, and patronage dividend withholding is not to apply where the individual files an exemption certificate with the payor of the dividend or interest, certifying that he reasonably believes he will not be liable for the payment of any income tax for the year in question (sec. 3483).

For those under age 18, the exemption certificates can be filed whether or not the individual expects to have any tax liability and once filed, need not be filed again. Instead the payors will remove their names from their exemption lists at the first of the year in which they become 18. Permanent exemption certificates are feasible in the case of children because of the relatively small proportion of them owing any tax.

The exemption certificates generally must be filed with the dividend or interest payor once a year. They may be filed with respect to bank account interest, patronage dividends, and certain dividend payments, but not with respect to corporate or Government bond

interest (other than savings bonds referred to below). An exception is necessary for corporate and Government bond interest because of the difficulty of making exemption certificates work where these bonds are transferred from one holder to another between interest payment dates, where one such holder might be exempt and the other not. Because of problems in handling the exemption certificates, for dividends to be eligible for exemption certification the stock must not be held in the name of a stockbroker or other nominee.

The exemption certificates apply in the case of series E savings bonds but instead of filing one exemption certificate a year in such cases, a separate exemption certificate is required to be filed with respect to each transaction in which these bonds are cashed in. This is necessary since these bonds may be cashed at different places.

The bill provides that anyone who willfully files an exemption certificate, knowing the certification to be fraudulent or false, is to be fined not more than $500 or imprisoned for not more than 1 year, or both.

In addition to the exemption certificates described above applicable where there is no tax liability, the bill provides for quarterly refunds payable during the year, where there is tax liability but the withholding is expected to be excessive. In the case of wage withholding it is possible for the payor to take into account directly the personal exemptions of the taxpayer. However, in the case of dividend, interest, and patronage dividend withholding, both because there is a much greater chance of multiple payors and also because of the greater likelihood of the purchase or sale of stock during the year, no system of having the payor take exemptions into account appears feasible. However, much the same effect is achieved by a quarterly refund system. Quarterly refunds are available to single persons expecting a gross income of less than $5,000 and married individuals and heads of households expecting a gross income of less than $10,000 a year. These quarterly refunds in no case are to be available for dependent children. (For treatment of refunds in their cases, see discussion below.)

Taxpayers whose gross income is expected to be below the specified amount may file one refund claim each quarter (at any time during the quarter). This claim may request a refund for any withholding on interest, dividends, or patronage dividends up to the amount of the taxpayer's "refund allowance." His "refund allowance" is 22 percent of—

(1) his expected deductions for personal exemptions, plus

(2) his expected retirement income, less

(3) any other taxable income he expects to receive which is not subject to dividend or interest withholding.

A subtraction must also be made for any refunds received in earlier quarters during the year. In effect this grants the taxpayer an exemption from withholding for his personal exemptions, retirement income credit, and (through a 22-percent factor rather than a 20-percent factor) his standard deduction similar to the exemption provided through employers for wage withholding.

Actually the taxpayer generally will need to compute his claim for refund only in the first quarter. In the second and third quarters it is expected that the Internal Revenue Service will automatically mail him partially completed refund claims refund, based upon the infor-

mation the taxpayer previously submitted. This procedure can be followed in all cases where the taxpayer indicates his income status has not changed significantly from his prior expectations. For the fourth quarter the refund is to be claimed on the regular tax return of the individual which he may file immediately after the end of the year.

To minimize small adjustments, the bill provides that the intra-annual refund claims may be filed only for amounts of $10 or over. However, where the excess withholding for one quarter may be below $10 but the cumulative amount for two or more quarters is above $10, an intra-annual refund is then permitted.

The manner in which the quick refund works can be illustrated by the example of a husband and wife, both over age 65, who receive interest payments of $1,500 four times a year. Assume that this is their only income and it is subject to withholding. Assume further that the couple expect to file a joint return for the year, are allowed four exemptions, and that each receives half of the income. Both are eligible for the maximum retirement income credit.

Calculation of refund allowance

(1) Allowance for exemptions (4×$600)	$2,400
(2) Plus: Allowance for retirement income credit ($1,200 for each of them)	2,400
(3) Less: Income subject to tax, other than dividends and interest subject to withholding	-----
(4) Total	4,800
(5) Refund allowance for year, 22 percent of line (4)	1,056

	1st quarter	2d quarter	3d quarter
(6) Amount withheld (20 percent of $1,500)	$300	$300	$300
(7) Refund allowance for year	1,056	1,056	1,056
(8) Refund for prior quarters		300	600
(9) Refund allowance (7)−(8)	1,056	756	456
(10) Refund (smaller of (6) or (9))	300	300	300

At the end of the year the couple will compute their tax ($120) in the usual manner. From this they will deduct the amount withheld. Initially $1,200 was withheld but through refunds in the first three quarters this was reduced to $300. After offsetting the tax of $120, there still would remain a refund of $180 at the end of the year. This could be claimed by filing the final return in January following the end of the year.

In addition to the use of exemption certificates and intra-annual refunds as outlined above, taxpayers required to file declarations of estimated tax may take credit on such declarations for amounts withheld with respect to interest and dividends in the same manner as they presently do in the case of wage and salary withholding (sec. 6015). In addition, an ordinary annual refund claim may be made with respect to excessive withholding on interest and dividends as is presently true of wage withholding (see amendment to sec. 6401).

One further type of crediting is also provided by the bill. This relates to withholding on interest, dividends, and patronage dividends received by dependent children of the taxpayer who have not filed exemption certificates. In such cases, if the child has not separately filed a claim for refund, and the child's gross income is less than $600

and is not subject to any wage withholding, then the parent of the child may, on the parent's return, claim a credit for the amount of the withheld tax with respect to the child's interest, dividend, or patronage dividend.

4. Exemption certificates, intraannual refunds and credits for governments and exempt organizations.—In the case of savings account and Government savings bonds the bill provides that exemption certificates can be filed by exempt organizations (other than exempt cooperatives). In these cases the exemption certificates once filed remain in effect as long as the organization is exempt. The same effect is achieved in the case of States, local governments, foreign governments and international organizations by the exceptions making withholding inapplicable in the case of the same types of interest.

The bill also provides that the governmental unit or tax-exempt organization may offset the withholding on dividends and interest income it receives against the amount it is required to withhold with respect to its employees for social security and Federal income tax purposes (sec. 3505).

In addition, refunds may be claimed in the case of these State or local governments or tax-exempt organizations for amounts not credited in the manner described above against social security or wage withholding taxes. These refunds may be made to the governmental unit or exempt organization on a quarterly basis during the year of liability. Quarterly refunds may also be filed by the U.S. Government and by foreign governments or international organizations and foreign central banks of issue (to the extent the income on which the withholding occurs in the latter case is not derived from any commercial banking functions (sec. 3485)).

5. Credits or refunds for corporations.—Because of the 85-percent intercorporate dividends received deduction, any net tax on dividends received by corporations is likely to be less than 8 percent. In addition to the low rate of tax applicable, there has been little difficulty in collecting tax from corporations. In view of these considerations, the bill permits the crediting or quarterly refunding of the entire amount withheld in the case of amounts received by corporations.

First, any amount withheld on interest and dividend payments received by corporations (including cooperatives) can be claimed as credits against the tax they are required to withhold with respect to their own dividend and interest payments (sec. 3487). For this purpose, withholding on interest and dividends received by one corporation may be claimed as credit against interest or dividend payments made by another corporation which is a member of the same affiliated group.

Any amount withheld with respect to interest and dividends received by a corporation in excess of the credits it claims with respect to its own withholding on interest and dividends may be refunded to the corporation on a quarterly basis (during the year of liability) (sec. 3486). In addition, for purposes of an estimated tax required of a corporation, any amount withheld (which is not credited or refunded as provided above) may be treated as a payment of the corporation's estimated tax (sec. 6655(f))

6. *Nonresident aliens and foreign corporations in the case of nominees.*—Although the present withholding statutory withholding rate on payments to nonresident aliens and foreign corporations is 30 percent, this rate has been lowered by regulations in many cases to conform with the tax rates under treaty provisions. As a result, the withholding rate applicable in these cases may be either above or below the 20 percent applicable under this bill to domestic dividend and interest payments. Where the dividend or interest payor makes the payment directly to the nonresident alien or foreign corporation, as under present law, he can apply the proper withholding rate. However, under present law where the interest or dividend payor makes the payment to a nominee, the latter withholds the appropriate amount.

Under the bill no special problem exists where the applicable withholding rate with respect to the nonresident alien or foreign corporation exceeds the 20-percent domestic withholding rate. In such cases where the nominee is the withholding agent he needs only to withhold the additional amount. A problem would exist, however, where the applicable withholding rate is less than the domestic 20-percent rate. This problem is met in the bill by providing that the amount required to be withheld, regardless of any treaty less than 20 percent. This, of course, does not change the actual rate of tax in such cases and any excess amounts withheld can be recovered by the aliens through refund claims. It is not intended that any inference should be drawn from the amendment as to whether there is presently any treaty requiring withholding at less than a 20-percent rate.

7. *Obligations sold between interest payment dates.*—Where an interest-bearing bond or other obligation is sold or exchanged between the interest payment dates, the bill provides that the amount withheld is to be treated as divided between the seller and the purchaser (or transferor and transferee) in proportion to the time (with respect to which the interest relates) which each holds title to the obligation. It is anticipated that the buyer and seller in such cases will take this treatment into account in the price at which the bond is sold. Thus, in the case of a $100 interest payment where the seller of the obligation has held the bond for half of the interest payment period in question, he presumably will demand $10 less than he otherwise would from the purchaser of the bond, since he knows that at the time of reporting his income for tax purposes he may claim a credit equal to this amount. Thus, he will demand of the purchaser one-half of the "net" interest (other factors being equal), or one-half of $80; namely, $40. This, plus the $10 for which he can claim a credit, will provide him with the interest for the half of the period for which he held the obligation.

8. *Effective date.*—In general, this provision is to apply in the case of interest and dividends paid on or after January 1, 1963. (However, in the case of transferable obligations, the bill is to apply only to interest paid with respect to interest-payment periods commencing on or after January 1, 1963). In the case of patronage dividends paid on or after January 1, 1963, the bill is to apply with respect to patronage occurring on or after the first day of the first taxable year of the cooperative beginning on or after January 1, 1963.

XXI. INFORMATION WITH RESPECT TO FOREIGN ORGANIZATIONS

(Sec. 20 of the bill and secs. 6038, 6046, and 6678 of the code)

A. Reasons for provision

Representatives of the administration in appearances before your committee have asked for the right to obtain more information with respect to operations of Americans abroad. First, with respect to the annual information return, now required of domestic corporations controlling foreign corporations, it was requested that this return also be required of individual citizens or residents of the United States controlling foreign corporations. Second, in addition to the various specified types of information now required to be submitted, it was also requested that the Treasury Department be permitted to require the furnishing of other information to that which is similar or related in nature to that specified in the existing provision. Third, existing law requires the supplying of this information with respect to a foreign subsidiary, or a subsidiary of such a subsidiary. It was desired that this information also be required of any other controlled foreign corporation. Fourth, it was requested that the definition of "control" be broadened to include most of the constructive ownership rules generally applied elsewhere in the code.

The administration also requested that the information return now required of officers, directors, and significant shareholders of foreign corporations upon the creation, organization, or reorganization of such corporations also be required of persons when they *become* officers, directors, or important shareholders.

In addition, the administration requested that a civil penalty be provided for those failing to file the returns as to organization, reorganization, etc., of foreign corporations. The penalty in this case is to be $1,000 unless it can be shown that the failure is due to reasonable cause.

Your committee agreed that the submission of this additional information was desirable to give greater assurance that the proper U.S. taxes are paid in the case of these foreign operations.

B. General explanation of provision

1. Annual information return.—In 1960 (Public Law 86-780), Congress enacted legislation providing that domestic corporations must furnish with respect to foreign corporations which they control and also with respect to foreign subsidiaries of any such foreign corporations information specifying—

(1) The name, place, and nature of business of the foreign corporation and country of incorporation;

(2) The accumulated profits of the foreign corporation or subsidiary, including items of income, deduction, and other items taken into account in computing these accumulated profits;

(3) A balance sheet of the foreign corporation or foreign subsidiary;

(4) Transactions between the foreign corporation or foreign subsidiary and (*a*) other foreign corporations or foreign subsidiaries controlled by the domestic corporation, (*b*) the domestic

corporation or (*c*) any shareholder owning at least 10 percent of the stock of the domestic corporation; and

(5) A description of the various classes of stock outstanding and name and address and number of shares held by each citizen or resident of the United States and domestic corporation holding 5 percent or more of the stock of the foreign corporation or foreign subsidiary.

Corporations failing to supply the information required received reductions in their foreign tax credit otherwise available with respect to the income derived from the foreign corporations or their subsidiaries, from 10 percent up, depending upon the period of time the failure continued.

Your committee's bill amends this information provision in several respects. First, it requires U.S. citizens or residents, domestic partnerships and domestic estates or trusts as well as domestic corporations controlling the foreign corporations to supply the information specified. Second, "control" is redefined by adding most of the constructive ownership rules of the existing section 318(a). Third, the bill also extends somewhat the type of foreign corporation with respect to which information must be supplied. Existing law applied to foreign corporations controlled by Americans and subsidiaries which they control. In other words, it applies to two levels of ownership of foreign corporations. The bill extends the requirement to apply to any number of levels of ownership so long as there is control of the corporations involved. Fourth, in addition to the listed types of information, the Treasury Department may also require the furnishing of any other information which is similar or related in nature to that specified.

2. Information with respect to organization, reorganization, etc.—Present law also requires U.S. citizens or residents who are officers or directors of a foreign corporation within 60 days of its creation, organization or reorganization, and also U.S. persons who within the same 60-day period own 5 percent of more of the value of the stock of the corporation, to supply information with respect to this corporation. The return is required to contain such information as the Secretary of the Treasury or his delegate prescribes by forms or regulation as necessary to carry out the provisions of the income tax laws.

Under existing law it is possible to avoid this information requirement where the U.S. citizen or resident first becomes an officer, director, or owner of 5 percent or more of the value of the stock of the corporation after the 60-day period. To prevent this avoidance of the information requirement the bill extends the requirement for supplying the information so that it applies to those U.S. citizens or residents who are officers, directors, or shareholders with more than a 5-percent interest on January 1, 1963, or who acquire such positions after that date. This information also is to be supplied with respect to shareholders whose holdings after that date are increased to 5 percent (or where they acquire an additional 5 percent of the stock of the corporation).

Your committee has also added a new section to the code providing a civil penalty in the case of any person required to file the return referred to here who fails to do so at the time required, or who files

a return which does not show the information required. The penalty in this case is to be $1,000 unless it is shown that the failure is due to reasonable cause.

3. Effective dates.—The amendments with respect to the annual information return apply with respect to annual accounting periods of the foreign corporations beginning after December 31, 1962. The amendments relating to the filing of returns as to organization, reorganization, etc., of foreign corporations takes effect on January 1, 1963.

XXII. TREATIES

(Sec. 21 of bill and sec. 7852(d) of code)

Section 7852(d) of the code provides that no provision of the Internal Revenue Title is to apply where its application would be contrary to any treaty obligation of the United States in effect on the date of the enactment of the Internal Revenue Code. Some believe that certain of the provisions of this bill may contravene provisions of existing income tax treaties. Your committee in the interest of forestalling any possible litigation on this point desired to make it clear that section 7852(d) is not to apply to any provision contained in this bill and if any provision of this bill should contravene any existing tax treaty, then the new statutory law is intended to have precedence over the prior treaty obligation.

XXIII. NEW ELECTION TO FILE SEPARATE RETURNS WHERE CONSOLIDATED RETURN HAD BEEN FILED

The Internal Revenue Code leaves to regulations issued by the Treasury Department requirements as to the filing of consolidated returns by an affiliated group and the requirements for changing from a consolidated return to separate returns. Generally it has been held that a consolidated return once filed must be continued in subsequent years unless there is a significant change in the tax laws. This is a matter which has been considered by your committee in connection with this bill and it believes that a new election to file separate returns where a consolidated return has previously been filed should be available for the first taxable year ending after the date of enactment of this bill.

TECHNICAL EXPLANATION OF THE BILL

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TECHNICAL EXPLANATION OF THE BILL

SECTION 1. SHORT TITLE, ETC.

(*a*) *Short title.*—Section 1(a) of the bill provides that the bill may be cited as the "Revenue Act of 1962."

(*b*) *Table of contents.*—Section 1(b) of the bill consists of a table of contents for the bill.

(*c*) *Amendment of 1954 Code.*—Section 1(c) of the bill provides that whenever in the bill an amendment or repeal is expressed in terms of an amendment to (or repeal of) a section or other provision, the reference is to be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

SECTION 2. CREDIT FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY

(*a*) *Allowance of credit.*—Section 2(a) of the bill redesignates section 38 of the code as section 40 and inserts a new section 38 in part IV of subchapter A of chapter 1 (relating to credits against tax).

Subsection (a) of the new section 38 provides that there is to be allowed, as a credit against the tax imposed by chapter 1 of the code, the amount determined under the new subpart B, added by section 2(b) of the bill. Subsection (b) of the new section 38 requires the Secretary of the Treasury or his delegate to prescribe such regulations as may be necessary to carry out the purposes of the new section 38 and the new subpart B.

(*b*) *Rules for computing credit.*—Section 2(b) of the bill adds a new subpart B to part IV of subchapter A of chapter 1 of the code. The new subpart consists of three sections (sec. 46–48) which are explained below.

SECTION 46. AMOUNT OF CREDIT

(*a*) *Determination of amount.*—Paragraph (1) of section 46(a) provides in general that the credit allowed for the taxable year is to be an amount equal to 8 percent of the qualified investment as defined in subsection (c) of section 46. Under paragraph (2) of section 46(a) the amount of the credit may not exceed so much of the liability for tax for the taxable year as does not exceed $100,000 plus 50 percent of so much of such liability as exceeds $100,000. However, the $100,000 amount provided by section 46(a)(2) is reduced in the case of certain married individuals filing separate returns (see sec. 46(a)(4)), corporations which are members of affiliated groups (see sec. 46(a)(5)), trusts and estates (see sec. 48(f)(3)), and certain other special types of taxpayers referred to in section 46(d).

Under paragraph (3) of section 46(a), the liability for tax for the taxable year is defined as the tax imposed by chapter 1 (including the 2-percent tax on consolidated taxable income) reduced by the sum of the credits against the income tax allowed by sections 33, 34, 35, and

37. For purposes of determining the liability for tax, the taxes imposed by sections 531 and 541 (relating, respectively, to the accumulated earnings tax and the personal holding company tax) are not considered taxes imposed by chapter 1. Thus, the liability for tax as defined in section 46(a)(3) and the credit allowable for the taxable year under section 38 are determined before computing any tax imposed by section 531 or 541.

Paragraph (4) of section 46(a) provides generally that, in the case of separate returns filed by a husband and wife, the credit allowed to each may not exceed so much of the liability for tax for the taxable year as does not exceed $50,000 plus 50 percent of so much of such liability as exceeds $50,000. However, this reduction in the limitation applies only if the taxpayer's spouse is entitled to an investment credit for the taxable year of such spouse which ends with, or within, the taxpayer's taxable year. Such spouse may be entitled to an investment credit either because of qualified investment for (whether directly made or whether allocated to such spouse by, for example, a subch. S corporation or a partnership), or because of an unused credit carryover to, such taxable year.

Paragraph (5) of section 46(a) provides generally that the $100,000 amount specified in subparagraphs (A) and (B) of section 46(a)(2) is to be reduced for each corporation which is a member of an affiliated group by apportioning $100,000 among the members of such group in the manner prescribed by regulations of the Secretary or his delegate. An affiliated group within the meaning of section 46(a)(5) is one described in section 1504(a), except that any corporation may be treated as a member of an affiliated group. Thus, an affiliated group for purposes of section 46(a)(5) may include any of the corporations excluded by section 1504(b) from being a member of an affiliated group for purposes of filing a consolidated return. For example, an affiliated group within the meaning of section 46(a)(5) could include a corporation exempt from taxation under section 501 or a foreign corporation.

The application of the limitation provisions of section 46(a) may be illustrated by the following example:

The qualified investment of an unmarried taxpayer is $2,050,000. His liability for tax for the taxable year is $185,000. The credit computed without regard to the limitation in section 46(a)(2) is $164,000 (8 percent of $2,050,000). The allowable credit for the taxable year is $142,500 ($100,000 plus 50 percent of $85,000).

(*b*) *Five-year carryover of unused credits.*—Subsection (b) of section 46 provides for a 5-year carryover of any unused credit. Under this provision, if the credit earned during the taxable year exceeds the limitation under section 46(a)(2) for that year (hereinafter referred to as "unused credit year"), the excess (the credit earned but not used to reduce tax for that year) is carried forward and added to the amount which would be allowable as a credit for each of the 5 succeeding taxable years to the extent the unused credit is not used to reduce tax for taxable years intervening between the unused credit year and the succeeding taxable year. The amount of the unused credit which may be so taken into account in any of the 5 succeeding taxable years is not to exceed the amount by which the limitation determined under section 46(a)(2) for such succeeding taxable year exceeds the sum of (1) the credit allowable for such succeeding taxable

year by reason of investment made in such year, and (2) other allowable unused credits which are attributable to years prior to the taxable year in which the unused credit originated. In determining the amount of the unused credit from a prior taxable year which may be taken into account in a succeeding taxable year, the credit allowable for the succeeding taxable year (determined without regard to carryovers of unused credits to that year) will first be applied. Unused credits originating from taxable years prior to the unused credit year will be applied next. If the credit earned and allowable for a succeeding taxable year, or the unused credits originating from taxable years prior to the unused credit year, exceed the limitation for such succeeding taxable year, the unused credit from the unused credit year will be carried forward to the next succeeding taxable year.

The application of the carryover of the unused credit provided for in subsection (b) of section 46 may be illustrated by the following example:

A taxpayer's credit based on his investment for the taxable year 1962 amounts to $120,000, and the limitation under section 46(a)(2) is $110,000. The taxpayer's unused credit for 1962 amounts to $10,000 ($120,000 minus $110,000), which he may carry forward to 1963 and the 4 succeeding taxable years. The credit based on his investment for 1963 is $135,000, and the limitation under section 46(a)(2) is $120,000. Since the taxpayer is limited to a credit of $120,000 for 1963, his total unused credits to be carried forward to 1964 amount to $25,000, $10,000 from 1962 and $15,000 from 1963. The credit based on his investment for 1964 is $135,000, and the limitation under section 46(a)(2) is $140,000. The taxpayer first applies the $135,000 for 1964 against the $140,000 limitation. He next applies any unused credit carried forward from 1962 against the remaining $5,000 allowable. Since the $10,000 credit carried forward from 1962 is in excess of the $5,000 remaining amount allowable for 1964, he has unused credits to carry over to 1965 of $20,000, $5,000 from 1962 and $15,000 from 1963.

(*c*) *Qualified investment.*—Paragraph (1) of section 46(c) defines "qualified investment" to mean, with respect to any taxable year, the aggregate of the applicable percentage of the basis of each new section 38 property placed in service by the taxpayer during such taxable year, plus the aggregate of the applicable percentage of the cost of each used section 38 property placed in service by the taxpayer during such taxable year. Under paragraph (2) of section 46(c), the applicable percentage to be applied to the basis (or cost) is: (1) 33⅓ percent if the estimated useful life is 4 years or more but less than 6 years, (2) 66⅔ percent if the estimated useful life is 6 years or more but less than 8 years, and (3) 100 percent if the estimated useful life is 8 years or more.

The basis of "new section 38 property" is to be determined under the general rules for determining the basis of property. Thus, the basis of property purchased or constructed would generally be its cost. If property is acquired in a nontaxable exchange to which section 1031 applies by trading in old property and paying a cash difference, the basis of the newly acquired property would be equal to the adjusted basis of the old property, plus the cash paid.

The cost of each "used section 38 property" is to be determined in accordance with section 48(c)(3)(B). However, the aggregate cost

of used section 38 property which may be taken into account in any taxable year in computing qualified investment cannot exceed $50,000. (See sec. 48(c)(2).)

The credit will apply to property only for the first taxable year such property is placed in service by the taxpayer. The date on which property is placed in service is the first date depreciation would be allowable to the taxpayer if he computed his depreciation deduction on a daily basis. Thus, in determining the date an asset is placed in service, the fact that the taxpayer, in computing his depreciation allowance, uses an assumed timing of additions under one of the "averaging conventions" is to be disregarded, but only for the purposes of the investment credit.

The estimated useful life of any property is to be determined as of the time such property is placed in service by the taxpayer, and with reference to the useful life in the hands of the taxpayer. Thus, if a taxpayer acquires used section 38 property with a remaining useful life of 3 years in his hands, such property will not qualify regardless of the original estimated useful life to the previous owner. See section 48(d) for the useful life to be used by certain lessees. The estimate of the useful life is to be based on the facts and circumstances known on the date the asset is placed in service.

An estimated useful life must be assigned to each separate property. Thus, if a taxpayer is using a multiple-asset account, he must assign a useful life to each asset in such account for the purpose of computing his qualified investment. If a taxpayer is using a method of depreciation, such as the units of production method, which does not measure useful life in terms of years, he must estimate useful life in years in order to compute his qualified investment.

The provisions of paragraphs (1) and (2) of section 46(c) may be illustrated by the following examples:

Example (1).—Corporation Y acquires and places in service during 1962 the following new and used section 38 assets:

Property	Estimated useful life	Basis or cost
	Years	
A (new)	5	$60,000
B (new)	10	90,000
C (new)	6	150,000
D (used)	4	30,000

Corporation Y's qualified investment for 1962 is $220,000 determined in the following manner:

Property	Basis or cost times applicable percentage	Qualified investment
A	$60,000×33⅓ percent	$20,000
B	$90,000×100 percent	90,000
C	$150,000×66⅔ percent	100,000
D	$30,000×33⅓ percent	10,000
Total		220,000

Example (2).—Mr. X, unmarried, owns and operates a business as a sole proprietorship and reports income on a calendar year basis.

He is also a member of the XYZ partnership, which is also on a calendar year basis. During 1962 Mr. X acquires and places in service in his sole proprietorship a new section 38 property having an estimated useful life of 9 years and a basis of $25,000. Also during 1962 the XYZ partnership acquires and places in service a new section 38 property having an estimated useful life of 4 years to the partnership and a basis of $18,000.

X's share of the basis of the new section 38 property acquired by partnership XYZ is $6,000. X's qualified investment for 1962 is $27,000, composed of $25,000 from his sole proprietorship (basis of $25,000 times applicable percentage, 100 percent), and $2,000 attributable to the property of the XYZ partnership (basis of $6,000 times applicable percentage, 33⅓ percent).

Public utility property

Paragraph (3)(A) of section 46(c) provides that in the case of section 38 property which is public utility property, the amount of the qualified investment is to be 50 percent of the amount ascertained under section 46(c)(1) with respect to such property.

Paragraph (3)(B) of section 46(c) defines "public utility property" as property used predominantly in the trade or business of the furnishing or sale of (i) electrical energy, water, or sewage disposal services, (ii) gas through a local distribution system, (iii) telephone service, or (iv) telegraph service by means of domestic telegraph operations (as defined in sec. 222(a)(5) of the Communications Act of 1934, as amended; 47 U.S.C., sec. 222(a)(5)), if the rates for such furnishing or sale have been established or approved by a State (as defined in sec. 7701(a)(10) of the code) or political subdivision thereof, by an agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof. The term "established or approved" by a State, etc., includes the filing of a schedule of rates with any of the named bodies having the power to approve such rates, even though such body has taken no action on the filed schedule.

If a taxpayer is engaged in one or more regulated activities enumerated in section 46(c)(3)(B) (hereinafter referred to as a utility activity) and is also engaged in a separate trade or business that is not considered a utility activity, property used in the latter trade or business is not subject to the reduction contained in paragraph (3)(A) of section 46(c). If property is used by a taxpayer both in a utility activity and a nonutility activity, the characterization of such property is to be based on the predominant use of such property during the taxable year the property is placed in service. Once property is characterized as public utility property, the fact that in any subsequent year such property is used predominantly in the nonutility business is to be disregarded.

"Public utility property" includes property leased to a taxpayer which uses such property predominantly in a utility activity. Thus, property leased to a taxpayer which uses the property predominantly in a utility activity during a taxable year is to be treated as public utility property for purposes of computing the lessor's credit. "Public utility property" also includes property which is leased to others by a taxpayer where the leasing of such property is part of its utility activity.

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Section 38 property which is not public utility property is not subject to the 50-percent reduction contained in section 46(c)(3)(A). Thus, for example, in the case of property which is used predominantly in international telegraph operations, which is not used predominantly outside the United States, and which otherwise qualifies as section 38 property, the qualified investment is to be determined without reduction by reason of section 46(c)(3)(A).

The provisions of section 46(c)(3) may be illustrated by the following example:

Corporation X is engaged in a trade or business of furnishing telephone services, the rates of which have been established by a public utility commission. Corporation X is also engaged in a separate nonutility trade or business. During 1962 corporation X acquires and places in service two new section 38 properties, each with a basis of $30,000 and an estimated useful life of 7 years. One of these properties is used exclusively in the utility activity. The other property is also used at times in the utility activity, but is used in the separate nonutility trade or business more than 50 percent of the time during the taxable year 1962. Corporation X's qualified investment is $30,000, which includes $20,000 attributable to nonutility property ($30,000 basis times applicable percentage, 66⅔ percent) plus $10,000 attributable to public utility property (50 percent times ($30,000 basis times applicable percentage, 66⅔ percent)).

(*d*) *Limitations with respect to certain persons.*—Subsection (d) of section 46 limits the applicability of the credit with respect to certain persons. Paragraph (1) of section 46(d) provides that both the qualified investment and the $100,000 amount specified under subparagraphs (A) and (B) of section 46(a)(2) are to be equal to a ratable share of such items in the case of the following organizations:

(1) mutual savings banks, cooperative banks, and domestic building and loan associations, to which section 593 applies;

(2) regulated investment companies and real estate investment trusts subject to tax under subchapter M; and

(3) cooperative organizations described in section 1381(a).

Under paragraph (2)(A) of section 46(d), in the case of a mutual savings bank, etc., its ratable share of the qualified investment and the $100,000 amount specified in subparagraphs (A) and (B) of section 46(a)(2) is equal to 50 percent of such items.

Under paragraph (2)(B) of section 46(d), in the case of a regulated investment company or a real estate investment trust, the qualified investment and the $100,000 amount specified in subparagraphs (A) and (B) of section 46(a)(2) are to be taken into account in the same proportion as its taxable income (as defined in sec. 852(b)(2) or section 857(b)(2), respectively) bears to such taxable income computed without regard to the deduction for dividends paid (as defined in sec. 852(b)(2)(D) or 857(b)(2)(C), respectively).

Under paragraph (2)(C) of section 46(d), a cooperative organization described in section 1381(a) is to take into account its qualified investment and the $100,000 amount specified in subparagraphs (A) and (B) of section 46(a)(2) in the same proportion as its taxable income bears to its taxable income increased by amounts to which section 1382 (b) or (c) applies and similar amounts the tax treatment of which is determined without regard to subchapter T (sec. 1381 and following). Thus, in the case of a taxable year of a cooperative

organization beginning before January 1, 1963, the denominator of the proportion for such organization is determined by adding to its taxable income any patronage dividends which are excluded or deducted and any nonpatronage distributions which are deducted under section 522(b)(1). In the case of any taxable year of the organization beginning after December 31, 1962, the denominator is determined by adding to taxable income (in addition to amounts to which sec. 1382 (b) or (c) applies) any amounts of the type described in the preceding sentence which are excluded or deducted without regard to section 1382 (b) or (c) because they are attributable to patronage occurring before 1963.

If any of these special taxpayers to which section 46(d) applies are members of an affiliated group as defined in section 46(a)(5), the \$100,000 amount specified in subparagraphs (A) and (B) of section 46(a)(2) is to be reduced in accordance with section 46(a)(5) before determining the ratable share of such item under section 46(d).

The provisions of section 46(d) may be illustrated by the following example:

The total qualified investment of a regulated investment company is \$150,000, and its investment company taxable income is \$50,000 after taking into account the deduction for dividends paid provided by section 852(b)(2)(D), and \$1 million without regard to such deduction. Such organization's qualified investment would be \$7,500 $\left(\$150,000 \times \frac{\$50,000}{\$1,000,000}\right)$. Similarly, the \$100,000 amount specified in subparagraphs (A) and (B) of section 46(a)(2) would be reduced to \$5,000 $\left(\$100,000 \times \frac{\$50,000}{\$1,000,000}\right)$, and the 50-percent limitation of section 46(a)(2)(B) would apply to the tax liability in excess of \$5,000.

SECTION 47. CERTAIN DISPOSITIONS, ETC., OF SECTION 38 PROPERTY

(*a*) *In general.*—Section 47 provides, in general, for an adjustment of prior credits (and credit carryovers) and an increase in the tax imposed by chapter 1 if property (1) is disposed of or otherwise ceases to be section 38 property with respect to the taxpayer before the close of the useful life which was taken into account with respect to such property in computing the credit, or (2) becomes public utility property. Subsection (a) of section 47 provides that adjustments due to the application of section 47 and increases in tax resulting from such adjustments are to be determined under regulations prescribed by the Secretary or his delegate.

Early disposition, etc.

Under paragraph (1) of section 47(a), the tax for a taxable year in which property is disposed of or otherwise ceases to be section 38 property before the close of the useful life which was taken into account in computing the credit is to be increased by the amount by which the credits allowed under section 38 for all prior taxable years have been decreased by reason of adjustments of the credits for such taxable

years. Such adjustment is to be made by recomputing qualified investment for the year in which the basis (or cost) of the property that ceases to be section 38 property was included in qualified investment and by recomputing the credit (and credit carryovers) accordingly. Qualified investment is to be recomputed by substituting, in lieu of the estimated useful life of the property that was originally taken into account in applying the applicable percentage, the period beginning with the time such property was placed in service by the taxpayer and ending with the time such property ceased to be section 38 property. This period is hereinafter referred to as the actual period of use. In determining the amount of the aggregate decrease in the credits allowed for all prior taxable years, due regard is to be accorded any previous recomputations of qualified investment, credits, and credit carryovers resulting from a prior application of section 47. Of course, if the actual period of use would have no effect on the appropriate applicable percentage to be applied, no adjustment is necessary. Thus, for example, if the estimated useful life is 10 years, and a disposition occurs resulting in an actual period of use of 8 years, no adjustment results, since the applicable percentage remains 100 percent in either case.

Except as provided in section 47(b), whenever section 38 property is disposed of, such property ceases to be section 38 property with respect to the taxpayer. In general, property will be considered disposed of whenever it is sold, exchanged, transferred, distributed, involuntarily converted, or disposed of by gift. Thus, a cessation will occur when property is contributed to a partnership or to a corporation. (However, see sec. 47(b) for an exception where the contribution of property constitutes a mere change in the form of operating the trade or business.) Generally, the lease of property is not considered to be a disposition for purposes of applying section 47. However, if a taxpayer leases out property which he would ordinarily dispose of by sale or exchange and it appears that a purpose of the lease is to avoid the application of section 47, then such lease will be considered a disposition.

Additional examples of property ceasing to be section 38 property include (1) property (or a portion thereof) which is no longer subject to depreciation with respect to the taxpayer because, for example, it is shifted from a business to a personal use, (2) property which is used in any taxable year predominantly outside the United States by a governmental unit, etc. Similarly, property of a partnership (or subch. S corporation or estate or trust) ceases to be section 38 property with respect to the taxpayer (partner, shareholder, or beneficiary) when such taxpayer sells his interest in the partnership (or shares of stock or beneficial interest). Furthermore, when section 38 property is leased, and the lessor elects to treat the lessee as the purchaser of the property under section 48(d), a termination of the lease and disposition of the property by the lessee will result in the application of section 47 with respect to the lessee.

The provisions of section 47(a)(1) may be illustrated by the following example:

Corporation X acquires and places in service a new section 38 asset on January 1, 1963. Such asset has a basis of $30,000 and an estimated useful life of 8 years. Assuming this is the only section 38 asset corporation X places in service during its taxable year ending

December 31, 1963, X's qualified investment is $30,000 ($30,000 basis times applicable percentage, 100 percent). Such investment entitles X to a credit of $2,400 (8 percent times $30,000). Corporation X's liability for tax for 1963 is $100,000, and X reduces its tax liability by the full $2,400. On January 1, 1968, corporation X sells such asset. There will be added to the taxes imposed by chapter 1 for X's taxable year ended December 31, 1968, $1,600 which is the aggregate decrease in credits allowed resulting solely from substituting a 5-year life for such asset in computing qualified investment in 1963. The sum of $1,600 is arrived at by first applying an applicable percentage of 33⅓ percent to the basis, resulting in an adjusted qualified investment of $10,000 ($30,000 basis times 33⅓ percent, the applicable percentage based on the actual period of use of 5 years). Since the recomputed qualified investment results in an adjusted credit of $800 (8 percent times $10,000) the aggregate decrease in credits is $1,600 ($2,400 credit allowed minus $800 adjusted credit).

Property becomes public utility property

Section 47(a)(2) provides that the credit is to be adjusted if during any taxable year any property previously taken into account in determining qualified investment as nonutility property becomes public utility property. Property becomes public utility property if in any one taxable year the property is used predominantly in a trade or business described in section 46(c)(3)(B) by the taxpayer or by a person leasing such property from the taxpayer. Once such property becomes public utility property in the hands of the taxpayer, the fact that in any subsequent year such property is used by such taxpayer predominantly in a nonutility activity is to be disregarded. (See sec. 46(c)(3)(B) for the definition of public utility property.)

In such a case, the tax liability for the taxable year in which the property becomes public utility property is to be increased by the amount that the credits allowed under section 38 for all prior taxable years is decreased by the adjustment. The adjustment is to be made by treating the property as public utility property beginning with the year the property was placed in service, but with due regard to the use of the property as nonutility property before such change in use. For purposes of the adjustment, it is assumed that the property will continue to be used as section 38 public utility property for the estimated useful life of the property which was taken into account in computing the credit in the year the property was placed in service.

The following table indicates the applicable percentage to be applied to the basis (or cost) of property which becomes public utility property for purposes of adjusting the credit. This table takes into account the 50-percent reduction required by section 46(c)(3)(A) in the case of public utility property, and gives due regard to the period during which the property is used as nonpublic utility property before the change in use.

	Original estimated useful life		
	4 to 6 years	6 to 8 years	8 years or more
If, before becoming utility property, property is held as nonutility property:			
Less than 4 years, the applicable percentage is	16⅔	33⅓	50
4 or 5 years, the applicable percentage is	33⅓	50	66⅔
6 or 7 years, the applicable percentage is	33⅓	66⅔	83⅓
8 years or more, the applicable percentage is	33⅓	66⅔	100

Thus, if property with an original estimated useful life of 8 years is used predominantly as public utility property after use as nonutility property for 4 years, the applicable percentage to be used in adjusting the credit under section 47(a)(2) is 66⅔ percent (in lieu of the applicable percentage of 100 originally used for nonutility property having a useful life of 8 years or more). If property becomes public utility property and section 47(a)(2) applies, and if such property is subsequently disposed of or used in a manner causing section 47(a)(1) to apply, proper adjustment for the fact that section 47(a)(2) has previously applied is to be made in applying section 47(a)(1).

Carryovers adjusted

Section 47(a)(3) provides that carryovers of unused credits under section 46(b) are to be adjusted by reason of a disposition or other cessation described in section 47(a)(1), or by reason of a change in use described in section 47(a)(2). Thus, even if the recomputation of qualified investment required by section 47(a)(1) does not result in a decrease in the credits allowed, credit carryovers are to be adjusted.

The provisions of section 47(a)(3) may be illustrated by the following example:

In 1962, corporation X acquired and placed in service a number of section 38 assets. One of these was asset A which has a basis of $300,000 and an estimated useful life of 8 years. X's qualified investment and tax liability for such year were $2 million and $200,000, respectively. In 1962, X's tentative credit was $160,000 (8 percent times $2 million), but because of the limitation contained in section 46(a)(2) the credit allowed for such year was $150,000 ($100,000 plus 50 percent of $100,000). Therefore, a $10,000 credit carryover was available for 1963 and succeeding years. On January 1, 1969, X trades in asset A in exchange for a new asset. Under these facts, corporation X must adjust its credit for 1962 by recomputing the qualified investment attributable to asset A. The original qualified investment with respect to asset A was $300,000 ($300,000 basis times applicable percentage, 100 percent); the recomputed qualified investment is $200,000 ($300,000 basis times applicable percentage, 66⅔ percent based on the actual period of use of asset A). Therefore, the total recomputed qualified investment is $1,900,000 ($2 million minus $100,000). In this case, the adjustment of the credit for 1962 will not affect the credit allowed in 1962 but will reduce the credit allowable as a carryover to 1963 and succeeding years. This is because in recomputing the credit, X's credit is reduced to $152,000 (8 percent times $1,900,000). Since X's adjusted credit is still in excess of the limitation of $150,000 for 1962, there is no decrease in credits allowed in 1962, and hence no increase in X's tax liability for 1969 attributable

to credits allowed in 1962. Thus, only the $10,000 unused credit carryover from 1962 is affected by the recomputation. Such carryover as adjusted is $2,000 ($152,000 adjusted credit for 1962 minus $150,000 credit used in 1962). To the extent more than $2,000 of the original carryover from 1962 has been used by the taxpayer as a credit against tax for 1963 or any succeeding year, such credits shall be adjusted and the decrease attributable thereto will be added to X's 1969 tax. However, if no more than $2,000 of the original $10,000 unused credit carryover has been used as a credit against tax, the result of the adjustment would be only to reduce the credit carryover.

(*b*) *Section not to apply in certain cases.*—Subsection (b) of section 47 provides exceptions to the adjustments required by section 47(a).

The first exception provides that section 47(a) will have no application to the transfer of property which arises by reason of an individual taxpayer's death. Thus, on the death of an individual taxpayer, the transfer of the decedent's property interests to his personal representative or heirs will be disregarded. Nor will section 47(a) apply to the transfer of a deceased taxpayer's interest held in joint tenancy (either as a joint tenant, or a tenant by the entirety) to the surviving owners of the property. The effect of this provision is that all properties held by a decedent at the time of his death for which the credit has been granted will be deemed held by the decedent for the useful life estimated by the decedent in computing his credits.

Another exception provided by subsection (b) of section 47 is that section 47(a) will not apply to the transfer of property to the acquiring corporation in a transaction to which section 381(a) applies. (See sec. 381(c)(23) for the treatment to be accorded the acquiring corporation with respect to the credits of the acquired corporation, including the sec. 47 adjustments with respect to dispositions by the acquiring corporation of property transferred by the acquired corporation.)

In addition, subsection (b) of section 47 provides, in effect, a suspension of the application of section 47(a) where there has been a mere change in the form of conducting a trade or business so long as (1) the property is retained in such trade or business as section 38 property, and (2) the taxpayer retains a substantial interest in such trade or business. On the occurrence of any event which results in a failure to meet either of the conditions described above, the property will be deemed to cease to be section 38 property when such event occurs. Thus, in determining whether the property ceases to be section 38 property before the close of its useful life, the period the property was held as section 38 property before the mere change in form of conducting the trade or business will be tacked on to the period beginning with the change in form and ending with the occurrence of the event which results in a failure to meet either of the conditions specified in the first sentence of this paragraph.

The phrase "a mere change in the form of conducting the trade or business" (whether through incorporation, the formation of a partnership, or otherwise) applies only to cases where the properties of a trade or business are transferred. Thus, the transfer of section 38 assets to a newly formed corporation in a transaction to which section 351 applies will not fall within the scope of the exception unless the transaction involves the transfer of the trade or business in which such assets were used.

The determination of whether the taxpayer has retained a substantial interest in the trade or business is to be made immediately after the change in form of conducting the business, as well as after each time the taxpayer disposes of a portion of his interest in the new enterprise. However, in any case where a taxpayer's interest in the business of the new enterprise remains constant in relation to his former interest, the taxpayer will be considered as having retained a substantial interest in the trade or business. Thus, where a taxpayer owns a 5-percent interest in a partnership, and after the incorporation of that partnership the taxpayer retains a 5-percent interest in the corporation, the taxpayer will be considered as having retained a substantial interest in the trade or business as of the date of the change in form.

The provisions of section 47(b) may be illustrated by the following examples:

Example (1).—On July 1, 1962, the XYZ partnership acquires and places in service asset A, a new section 38 asset, with a basis of $30,000 and an estimated useful life of 8 years. One-third of the basis of such asset is taken into account by each of the three partners of the XYZ partnership in computing their individual credits. On January 1, 1964, the XYZ partnership transfers all of its assets to the XYZ corporation, a newly formed corporation, in exchange for all of the stock of XYZ corporation. Such stock is then transferred pro rata to the partners. The XYZ corporation continues to operate the same trade or business formerly conducted as a partnership. On September 1, 1970, the XYZ corporation sells asset A. Assuming all the partners have continuously retained a substantial interest in the XYZ corporation and asset A was used in the business as a section 38 asset until September 1, 1970, no adjustment is required under section 47 since the total holding period of asset A for each partner exceeds 8 years (18 months while used by the XYZ partnership and 80 months while used by the XYZ corporation or a total of 8 years and 2 months).

Example (2).—On January 1, 1962, the X corporation acquires and places in service a new section 38 property (with an estimated useful life of 6 years) which it takes into account in computing a credit. Such property is used in X's manufacturing business. X corporation is also engaged in a separate personal service business. In 1963, the X corporation transfers the assets of the manufacturing business (including the sec. 38 property upon which the X corporation took a credit) to a newly formed corporation, the Y corporation. X corporation then transfers to its shareholders all of the stock of the Y corporation. Since the X corporation does not retain a substantial interest in the manufacturing business, section 47(a) will apply to the transfer of the assets to Y corporation.

(c) *Special rule*.—Subsection (c) of section 47 provides a special rule for treating the increase in tax resulting from the adjustment of the credit. In general, such increase in tax will be treated as a tax imposed by chapter 1. However, it will not be so treated for purposes of determining the amount of the credits under section 33 (relating to tax of foreign countries and possessions of the United States), section 34 (relating to dividends received by individuals), section 35 (relating to partially tax-exempt interest received by individuals), section 37 (relating to retirement income), and section 38 (relating to investment in certain depreciable property). Thus, the increase in tax is not to

be taken into account in determining a taxpayer's liability for tax as defined in section 46(a)(3), and hence will have no effect on the limitation contained in section 46(a)(2). However, all adjustments to credit carryovers to the current taxable year resulting from a cessation or change in use during such taxable year are to be taken into account in determining the amount of credit carryovers which may be used for such year.

SECTION 48. DEFINITIONS; SPECIAL RULES

(*a*) *Section 38 property.*—Section 48 contains various definitions and special rules necessary to the application of the investment credit. Section 48(a) defines the type of property investment which will qualify for the credit.

In general

The term "section 38 property" is defined by section 48(a)(1) as property which is tangible personal property, or which is other tangible property (not including a building and its structural components) but only if such other property is used as an integral part of manufacturing, production, extraction, or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or is a research or storage facility used in connection with any of the foregoing activities. The property described above, however, must be property with respect to which depreciation (or amortization in lieu of depreciation) is allowable, and such property must have a useful life of 4 years or more (determined as of the time such property is placed in service). (See the discussion of useful life in this report under sec. 46(c), relating to qualified investment.)

If an asset is in part subject to an allowance for depreciation and in part nondepreciable, only the proportionate part of the asset which is subject to depreciation will qualify as section 38 property. Thus, if an asset is used 80 percent of the time in a trade or business and is used 20 percent of the time for personal purposes, only 80 percent of such property will qualify as section 38 property subject to depreciation. Further, property does not qualify to the extent it is treated as property which is used for personal, living, and family purposes under section 274 (relating to disallowance of certain entertainment, etc., expenses).

Property may qualify as section 38 property if amortization is allowable with respect to such property in lieu of depreciation. Amortization in lieu of depreciation is allowable, for example, if a lessee makes improvements on leased property which have a longer estimated useful life than the remaining term of the lease and amortizes the cost of such improvements over the remaining term of the lease.

Tangible personal property may qualify as section 38 property irrespective of whether it is used as an integral part of manufacturing, production, or extraction or of the furnishing of transportation, communications, electrical energy, gas, water, or sewage disposal services. Local law definitions will not be controlling for purposes of determining the meaning of the term "tangible personal property." For purposes of section 48, the term "tangible personal property" includes any tangible property except land, and improvements thereto, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings

or structures). Assets accessory to the operation of a business, such as machinery, printing presses, transportation or office equipment, refrigerators, individual air-conditioning units, grocery counters, etc., generally constitute tangible personal property for purposes of section 48, even though such assets may be termed fixtures under local law. Further, assets in the nature of machinery will be considered "tangible personal property" for purposes of section 48 whether they are placed within or without a building or other structure. Thus, for example, a gasoiine pump, or a hydraulic car lift, although not within any structure, will nevertheless be considered "tangible personal property." Intangible property, such as patents and copyrights, does not qualify as section 38 property.

Buildings and structural components thereof are not eligible for the credit. The term "building" is to be given its commonly accepted meaning, that is, a structure or edifice enclosing a space within its walls, and usually covered by a roof. It is the basic structure of an improvement to land the purpose of which is, for example, to provide shelter or housing or to provide working, office, display, or sales space. The term would include, for example, the basic structure used as a factory, office building, warehouse, theater, railway or bus station, gymnasium, or clubhouse. The term "structural components" of a building includes such parts of the building as central air-conditioning and heating systems, plumbing, and electric wiring and lighting fixtures, relating to the operation and maintenance of the building.

In addition to tangible personal property, other tangible property (not including a building and its structural components) used as an integral part of the manufacturing, production, or extraction process or as an integral part of a system of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services may qualify for the credit. Property is to be considered as being used as an integral part of a system of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services only if such property is used by one engaged in the trade or business of furnishing such services. Thus, if a manufacturing firm constructs an airstrip for use by airplanes operated for the convenience of its officers and employees, such airstrip would not qualify as section 38 property since the manufacturing firm is not engaged in the transportation business.

The terms "manufacturing," "production," "extraction," and the businesses of furnishing "transportation," "communications," "electrical energy," "gas," "water," or "sewage disposal" services are to be given their commonly accepted meaning. Thus, for example, manufacturing or production includes the construction, reconstruction, or making of property from or with scrap, salvage, or junk material, as well as from new or raw material, (1) by processing, manipulating, refining, or changing the form of an article, or (2) by combining or assembling two or more articles, and includes the cultivation of the soil and the raising of livestock and other farm produce. Section 38 property would include, for example, property used as an integral part of the extraction, processing, refining, and fabrication of minerals or mineral products; the growing, raising, processing, and packing or packaging of foodstuffs; the operation of sawmills and the production of lumber and lumber products and other building materials; and the manufacture, treatment, and packaging of textiles, paper, leather

goods, glass, etc. Examples of transportation businesses would be railroads and airlines. Examples of communications businesses would include businesses furnishing telephone and telegraph services or radio or television broadcasting stations.

In order to qualify for the credit, property (other than tangible personal property and research or storage facilities used in the specified activities) must be used as an integral part of one or more of the specified activities. Thus, for example, section 38 property would ordinarily not include such assets as pavements, parking areas, advertising displays, outdoor lighting facilities, or swimming pools which, although used as a part of the overall business operation, are not used directly in the specified activities. Specific examples of qualifying property which normally would be used as an integral part of one of the specified activities are blast furnaces, oil and gas pipelines, and railroad tracks and signals. Fences will qualify as section 38 property where used as an integral part of a specified activity as, for example, where used in connection with the raising of livestock.

Research or storage facilities (other than buildings) are eligible for the credit if used in connection with any of the specified activities, although such property is not an integral part of the activity.

Property used outside the United States

Subparagraph (A) of section 48(a)(2) provides that, subject to certain exceptions contained in subparagraph (B) of that section, the term "section 38 property" does not include property used predominantly outside the United States (as defined in sec. 7701(a)(9)). The term "predominantly outside the United States" means that the property must be physically located outside the United States more than 50 percent of the time during any one taxable year. Thus, if property is originally placed in service in the United States and a credit is received on such property, but such property is thereafter in any one year used predominantly outside the United States, such property ceases to be section 38 property with respect to the taxpayer who obtained the credit, regardless of the fact that the property is later returned to the United States. Furthermore, if property is originally placed in service by the taxpayer outside the United States and is used predominantly outside the United States during the taxable year originally placed in service, such property cannot qualify as section 38 property with respect to such taxpayer.

Subparagraph (B)(i) of section 48(a)(2) provides that any aircraft which is registered by the Administrator of the Federal Aviation Agency and which is operated, whether on a scheduled or nonscheduled basis, to and from the United States may be section 38 property even though it is used predominantly outside the United States. The term "to and from" the United States is not intended to exclude an aircraft which makes flights from one point in a foreign country to another such point, as long as such aircraft returns to the United States with some degree of frequency.

Subparagraph (B)(ii) provides that rolling stock of a domestic railroad corporation subject to part I of the Interstate Commerce Act which is used within and without the United States does not lose its eligibility for the credit even though it is used predominantly outside the United States. For the purposes of subparagraph (B)(ii)

the term "rolling stock" means locomotives, freight and passenger train cars, floating equipment, and miscellaneous transportation equipment on wheels, the expenditures for which are chargeable to the equipment investment accounts in the uniform system of accounts for railroad companies prescribed by the Interstate Commerce Commission.

Subparagraph (B)(iii) provides that any vessel which is documented under the laws of the United States and which is operated in the foreign or domestic commerce of the United States may qualify as section 38 property.

Subparagraph (B)(iv) provides that any motor vehicle of a United States person (as defined in sec. 7701(a)(30)) which is operated to and from the United States with some degree of frequency may be section 38 property even though predominantly used outside the United States.

Subparagraph (B)(v) provides that any container of a United States person which is used in the transportation of property to and from the United States may be section 38 property even though used predominantly outside the United States.

Subparagraph (B)(vi) provides that property (other than vessels or aircraft) of a United States person which is used for the purposes of exploring for, developing, removing, or transporting resources from the outer Continental Shelf of the United States (within the meaning of sec. 2 of the Outer Continental Shelf Lands Act as amended and supplemented; 43 U.S.C., sec. 1331) may be section 38 property. Thus, for example, the credit may be allowed for offshore drilling equipment.

Property used for lodging

The first sentence of paragraph (3) of section 48(a) provides that the term "section 38 property" does not include property which is used predominantly to furnish lodging or is used predominantly in connection with the furnishing of lodging. Thus, if property is used predominantly to furnish lodging in the year it is placed in service, it does not qualify as section 38 property. If property on which a credit has been allowed is used predominantly to furnish lodging in any subsequent year, such property will cease to be section 38 property. Property which is generally considered to be used to furnish lodging includes beds and other furniture and fixtures used in the accommodations for lodging.

The second sentence of section 48(a)(3) provides two exceptions to the rule excluding from the credit property used for lodging or in connection with the furnishing of lodging. Subparagraph (A) of such second sentence provides that nonlodging commercial facilities which are available to persons not using the lodging facilities on the same basis that they are available to persons using the lodging facilities may qualify for the credit. For example, tangible personal property used in a restaurant or pharmacy may qualify as section 38 property notwithstanding the fact that the restaurant or pharmacy is operated in connection with lodging facilities such as an apartment house. However, the furniture and fixtures, rugs, draperies, etc. used, for example, in the lobby of an apartment house would be excluded since they are furnished in connection with the furnishing of lodging and

since the lobby of an apartment house is not a nonlodging commercial facility.

Subparagraph (B) of the second sentence of section 48(a)(3) provides that property used by a hotel or motel in connection with the trade or business of furnishing lodging may qualify for the credit where the predominant portion of the accommodations is used by transients. Thus, if more than half of the rooms used to accommodate guests of a hotel or motel are normally used on a transient basis, the property used in such hotel or motel may qualify for the credit even though it is used in connection with furnishing lodging. Conversely, if less than half of the accommodations are normally used on a transient basis, none of the property used in the hotel or motel may qualify for the credit except for property used in connection with a nonlodging commercial facility.

Property used by tax-exempt organizations

Paragraph (4) of section 48(a) provides that property used by an organization (other than a cooperative described in sec. 521) which is exempt from the tax imposed by chapter 1 of the code shall be treated as section 38 property only if such property is used predominantly in an unrelated trade or business the income of which is subject to tax under section 511. The term "property used by" an organization exempt from tax includes property leased to such an organization, as well as property leased by such an organization to another person. Thus, if property does not qualify under section 48(a)(4) because it is leased to an organization exempt from tax, no credit is allowable to the lessor with respect to such property.

Property used by governmental units

Paragraph (5) of section 48(a) also excludes from the term "section 38 property" property used by the United States, any State (as defined in sec. 7701(a)(10) of the code) or political subdivision thereof, any international organization (as defined in sec. 7701(a)(18) of the code), or any agency or instrumentality of any of the foregoing.

(*b*) *New section 38 property.*—Subsection (b) of section 48 provides that, for purposes of the credit, "new section 38 property" means only section 38 property, the construction, reconstruction, or erection of which is completed by the taxpayer after December 31, 1961, or acquired by the taxpayer after that date provided the original use of such property commences with the taxpayer and commences after such date. In the case of property constructed, reconstructed, or erected by the taxpayer, there is to be taken into account in determining the basis of such property only that portion of the basis which is properly attributable to construction, reconstruction, or erection after December 31, 1961. The principles applicable under section 167(c) of the code are to be applied under section 48(b) in determining, for example, when the property is acquired by the taxpayer, whether the original use of the property commences with the taxpayer, and the portion of the basis of property completed after December 31, 1961, which is attributable to construction, reconstruction, or erection after that date.

(*c*) *Used section 38 property.*—Paragraph (1) of section 48(c) defines the term "used section 38 property" as section 38 property acquired by purchase after December 31, 1961, which is not new section 38 property.

Used section 38 property does not include property which, after its acquisition by the taxpayer, is used by a person who used such property before such acquisition. This rule also applies where the property after acquisition by the taxpayer is used by a person who is related to a person who used the property before acquisition. Such person will be considered as related if the relationship is one described in section 179(d)(2) (A) or (B) (as, for example, where the parties are members of an affiliated group, as defined in sec. 48(c)(3)(C)). Thus, if property were sold under a sale and leaseback arrangement, such property in the hands of the purchaser-lessor would not be used section 38 property since the property, after its acquisition, is being used by the same person who used it before the acquisition. Similarly, where a taxpayer has been leasing property, and subsequently purchases such property (whether or not the lease contained a purchase option feature), such property is not used section 38 property with respect to such taxpayer, since it is being used by the person who used such property before its acquisition. In addition, if property owned by a lessor is sold subject to a lease or is sold upon the termination of a lease, the property will not qualify as used section 38 property with respect to the purchaser, if thereafter the property is used by a lessee who used the property before the acquisition. For purposes of applying the rule contained in section 48(c)(1), property will be considered used by a person only if a substantial use is made. Thus, property would not be disqualified as used section 38 property merely because a person using the property after acquisition had also made some casual use of it before acquisition.

Dollar limitation

Under subparagraph (A) of section 48(c)(2), the cost of used section 38 property which may be taken into account under section 46(c)(1)(B) in computing qualified investment for any taxable year is not to exceed $50,000. If the total cost of used section 38 property placed in service during the taxable year exceeds $50,000, the taxpayer must select the particular assets he wishes to be taken into account in computing qualified investment (but not to exceed an aggregate cost of $50,000). The selection of the specific assets to be taken into account is to be made at the time and in the manner prescribed by regulations. Such selection may be changed only in the manner and to the extent provided by the regulations. Thus, if a taxpayer has a cost of used section 38 property of $25,000 acquired in connection with the operation of a sole proprietorship, $30,000 allocated to him from a subchapter S corporation, and $20,000 which is his share of the cost of used section 38 property acquired by a partnership of which he is a member, he may select from the total of $75,000 the particular assets which he wishes to take into account for purposes of computing qualified investment. If the assets selected all have useful lives of between 4 and 6 years, the maximum qualified investment in used section 38 property will be $16,667. If the assets selected all have useful lives in excess of 8 years, qualified investment in used section 38 property would be $50,000.

Subparagraph (B) of section 48(c)(2) provides that in the case of a husband or wife filing a separate return, the cost of used section 38 property that may be taken into account is not to exceed $25,000. If this subparagraph applies, and such cost exceeds $25,000, the

husband or wife may select, under regulations prescribed by the Secretary of the Treasury or his delegate, the assets to be taken into account, but only to the extent of an aggregate cost of $25,000. Subparagraph (B) shall apply, however, only if the spouse of the taxpayer has purchased (or has been allocated) used section 38 property which may be taken into account in qualified investment for the taxable year of such spouse which ends within or with the taxpayer's taxable year. Thus, if both husband and wife have purchased (or have been allocated) any used section 38 assets for the taxable year (as described above) and they file separate returns, the maximum cost of used section 38 property which may be taken into account by each is $25,000; but if only one spouse has purchased (or has been allocated) any used section 38 assets, such spouse may take into account $50,000 of the cost of used section 38 property.

Subparagraph (C) of section 48(c)(2) provides that in the case of an affiliated group, the $50,000 limitation is to be reduced for each member of the group by apportioning the $50,000 limitation among the members of the affiliated group in accordance with their respective amounts of used section 38 property which may be taken into account. The phrase, "their respective amounts of used section 38 property which may be taken into account", has reference to the total cost of used section 38 property without regard to the $50,000 limitation or the applicable percentages to be applied in computing qualified investment. An affiliated group is one defined in section 1504(a) except that the phrase "more than 50 percent" is to be substituted for the phrase "at least 80 percent" each place it appears in section 1504 (a), and all corporations are to be treated as includible corporations. Thus, even if a corporation is excluded under section 1504(b) from being a member of an affiliated group for purposes of filing a consolidated return, it nevertheless will be treated as an includible corporation for purposes of section 48(c).

Subparagraph (D) of section 48 (c)(2) provides that, in the case of partnerships, the limitation on the amount of used section 38 property which may be taken into account is to apply both with respect to the partnership and with respect to each partner. Thus, a partnership will be limited to used section 38 property having a cost of $50,000 regardless of the number of partners.

If the aggregate cost of used section 38 property purchased by the partnership during a taxable year exceeds $50,000, the partnership, under regulations prescribed by the Secretary of the Treasury or his delegate, is to select the properties, the cost of which is to be taken into account by the partners. Each partner will then combine his share of the cost of the used section 38 property selected by the partnership with the cost of any other used section 38 property to which he may be entitled. This combined amount may not exceed $50,000 (or $25,000 in the case of certain married individuals under section 48(c)(2)(B)). If such amount exceeds $50,000, the taxpayer will then select the properties to which the applicable percentages are to be applied in computing his qualified investment.

Definitions

Subparagraph (A) of section 48(c)(3) provides that the principles of section 179(d)(2) of the code are to be applied in determining whether the property has been acquired by purchase. Thus, for

example, used section 38 property is not acquired by purchase if it is acquired from a person whose relationship to the person acquiring it would result in the disallowance of a loss under section 267 or 707(b) (except that in applying sec. 267 (b) and (c), the family of an individual includes only his spouse, ancestors, and lineal descendants, and not his brothers and sisters). Furthermore, the term "purchase" does not include the acquisition of property by one member of an affiliated group (as defined in sec. 48(c)(3)(C)) from another member of the same affiliated group, or the acquisition of property the basis of which is determined in whole or in part by reference to the adjusted basis in the hands of the person from whom acquired, or under 1014(a) (relating to property acquired from a decedent).

Subparagraph (B) of section 48(c)(3) provides that the cost of used section 38 property does not include so much of the basis of such property as is determined by reference to the adjusted basis of other property held at any time by the person acquiring such property. Thus, for example, if the basis of used section 38 property acquired is determined under section 1031 (relating to certain nontaxable exchanges), the preceding rule applies. In addition, if property is disposed of and used section 38 property which is similar or related in service or use is acquired as a replacement therefor (whether before or after the disposition), in a transaction to which the preceding rule does not apply, the cost of the used section 38 property acquired is the basis of such property, reduced by the adjusted basis of the property replaced. In such a case, if the basis of the replacement asset is $2,000 and the adjusted basis of the replaced asset is $1,200 at the time of its disposition, the cost of used section 38 property would be $800. Notwithstanding the rules described in this paragraph, the cost of used section 38 property is not to be reduced by the adjusted basis of any property disposed of if by reason of section 47 the disposition of such property gives rise to an increase of tax or a reduction of unused credit carryovers.

(*d*) *Certain leased property.*—Subsection (d) of section 48 provides that in certain cases where property is leased to another by a person engaged in the business of leasing property, such person may elect to treat the lessee as having acquired such property. This rule applies only with respect to property which is new section 38 property in the hands of the lessor. Thus, for example, the election may not be made with respect to property owned by an organization exempt from tax unless the property is used predominantly in an unrelated trade or business of leasing, the income of which is subject to tax under section 511.

In addition, the election may be made only with respect to the first lessee of such new section 38 property, and only if such property would constitute new section 38 property if such lessee had actually acquired the property. Thus, for example, the election cannot be made if the first lessee uses the property predominantly outside the United States.

Also, for purposes of determining whether such propery would constitute new section 38 property if purchased by the lessee, the original use of the property will be deemed to commence with the first lessee if he is the first person to use such property for its intended function. Thus, the fact that the lessor may have, for example, tested, stored, or attempted to lease the property to other persons will not preclude the lessee from being deemed the original user as

long as neither the lessor nor any other person has physically used the property for its intended function before its use by the lessee. Moreover, in determining whether the property qualifies as new section 38 property to the lessee and in determining the amount of his qualified investment with respect to such property, the estimated useful life of the property to the lessee will be deemed to be the estimated useful life in the hands of the lessor. The election is not available if the lessor is a person referred to in section 46(d); i.e., a mutual savings bank, cooperative bank, or domestic building and loan association to which section 593 applies; a regulated investment company or real estate investment trust subject to taxation under subchapter M; or a cooperative organization described in section 1381(a).

If the election is made, the lessee will be treated for all purposes of subpart B as though he had acquired the property. Thus, if the leased property is disposed of by the lessee, or if it otherwise ceases to be section 38 property to him, such property will be subject to the provisions of section 47 applicable to such cessations. Also, if the first lessee of property is treated as having acquired such property, the lessor is thereafter precluded from obtaining a credit as to such property. The election under section 48(d) will be made at such time, in such manner, and subject to such conditions as may be provided in regulations prescribed by the Secretary of the Treasury or his delegate.

In any case in which the lessee is treated as having acquired the property, the lessee's investment is deemed to be equal to the fair market value of the property if such property is constructed by the lessor or by a corporation which controls or is controlled by the lessor within the meaning of section 368(c). In any other case the lessee's investment is the basis of the property in the hands of the lessor.

The provisions of section 48(d) may be illustrated by the following example:

X corporation is engaged in the business of manufacturing and leasing new and reconditioned equipment which in its hands has an estimated useful life of 8 years. After December 31, 1961, X corporation constructs machine No. 1, having a fair market value of $15,000 and a cost of $10,000, and reconditions machine No. 2 at a cost of $5,000. Y corporation leases both machines from X immediately after their construction and reconditioning and before X has made any other use of such machines. As to machine No. 1, if X elects to treat the property as being acquired by Y, such machine will have a basis of $15,000 in Y's hands, and an estimated useful life of 8 years, for purposes of determining qualified investment (assuming the property otherwise qualifies as new section 38 property in Y's hands). The election is not available with respect to machine No. 2, since a reconditioned machine would not constitute new section 38 property if the lessee had purchased it. In such a case, while X corporation cannot make the election to let the Y corporation take the credit, X corporation would be entitled to a credit based on its expenditure of $5,000 as an investment in new section 38 property, the reconstruction of which is completed after December 31, 1961.

(*e*) *Subchapter S corporations.*—Subsection (e) of section 48 provides for the application of the credit in the case of an electing small business corporation under subchapter S. The qualified investment of the subchapter S corporation is allocated pro rata among the

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persons who are shareholders on the last day of the corporation's taxable year. The qualified investment is ascertained at the corporate level, and thus the aggregate cost of used section 38 property that may be allocated to the shareholders is limited to $50,000. If the cost of used section 38 property purchased by the subchapter S corporation exceeds $50,000 in any one taxable year, the corporation is to select, under regulations prescribed by the Secretary of the Treasury or his delegate, the properties the cost of which may be taken into account by its shareholders.

Any person to whom an investment is apportioned under subsection (e) of section 48 is to be treated as the taxpayer with respect to such investment, and such investment will not (by reason of such apportionment) lose its character in his hands as an investment in either new or used section 38 property. Thus, each shareholder will take into account, in determining his own qualified investment, his allocated share of the corporation's qualified investment in new section 38 property. He will also take into account his allocated share of the corporation's investment in used section 38 property. Of course, since only $50,000 cost of used section 38 property may be taken into account, if a shareholder's combined cost of used section 38 property exceeds $50,000, he must select the properties to be taken into account in computing his qualified investment.

If a shareholder includes in his qualified investment any portion of the basis or cost of property acquired by the subchapter S corporation and the corporation subsequently disposes of such property, or if the shareholder disposes of his stock in such corporation, the shareholder will be subject to the provisions of section 47 with respect to such property.

(*f*) *Estates and trusts.*—Subsection (f) of section 48 provides rules for applying the investment credit to estates and trusts. Paragraph (1) of section 48(f) provides that the qualified investment for any taxable year is to be apportioned between the estate or trust and the beneficiaries on the basis of the income of the estate or trust allocable to each. The qualified investment is ascertained at the trust or estate level, and thus the aggregate cost of used section 38 property that may be apportioned between the estate or trust and the beneficiaries is limited to $50,000. If the cost of used section 38 property purchased by the estate or trust exceeds $50,000 in any one taxable year, the estate or trust is to select, under regulations prescribed by the Secretary of the Treasury or his delegate, the properties the cost of which may be taken into account.

Paragraph (2) of section 48(f) provides that any beneficiary to whom the investment is apportioned is to be treated as the taxpayer with respect to such investment, and such investment will not (by reason of such apportionment) lose its character as an investment in either new or used section 38 property. If the combined cost of used section 38 property available from all sources to any beneficiary exceeds $50,000, such beneficiary must select the properties the cost of which is to be taken into account in computing his qualified investment. The term "beneficiaries" as used in section 48(f) includes heirs, legatees, and devisees.

Paragraph (3) of section 48(f) provides that the $100,000 amount specified under subparagraphs (A) and (B) of section 46(a)(2) applicable to such estate or trust is to be reduced to an amount which

bears the same ratio to $100,000 as the amount of the qualified investment allocated to the estate or trust under paragraph (1) of section 48(f) bears to the entire amount of the qualified investment. Thus, in a case where the qualified investment of the estate or trust is $1 million, and $250,000 of such amount is allocated to the estate or trust because 25 percent of the income is allocable to the estate or trust, the $100,000 amount in the case of such estate or trust is reduced to $25,000.

SECTION 2. CREDIT FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY (Continued)

(*c*) *Certain corporate acquisitions.*—Subsection (c) of section 2 of the bill provides an amendment to section 381(c) of the 1954 Code (relating to the carryover of tax attributes in the case of certain corporate acquisitions) by adding paragraph (23) thereto. Section 381 (c)(23) provides that the acquiring corporation is to take into account (to the extent proper to carry out the purposes of sec. 381 and sec. 38, and under such regulations as may be prescribed by the Secretary of the Treasury or his delegate) the items required to be taken into account for purposes of section 38 in respect of the distributor or transferor corporation. Thus, for example, the regulations under section 381(c)(23) will provide rules for the carryover of any unused credit carryovers of the distributor or transferor corporation and for the application of section 47 to dispositions by the acquiring corporation of property acquired from the distributor or transferor corporation.

(*d*) *Clerical amendment.*—Subsection (d) of section 2 of the bill provides a clerical amendment to part IV of subchapter A of chapter 1 of the 1954 Code.

(*e*) *Effective date.*—Subsection (e) of section 2 of the bill provides that the amendments made by section 2 of the bill are to apply with respect to taxable years ending after December 31, 1961.

SECTION 3. APPEARANCES, ETC., WITH RESPECT TO LEGISLATION

(*a*) *In general.*—Subsection (a) of section 3 of the bill amends section 162 (relating to trade or business expenses) by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) a new subsection (e) relating to appearances, etc., with respect to legislation.

Paragraph (1) of the new subsection (e) provides that the deduction allowed by subsection (a) of section 162 is to include all of the following ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business: (1) expenses in direct connection with appearances before, submission of statements to, or sending communications to, the committees, or individual members, of Federal, State, or local legislative bodies with respect to legislation or proposed legislation of direct interest to the taxpayer, (2) expenses in direct connection with communication of information between the taxpayer and an organization of which he is a member with respect to legislation or proposed legislation of direct interest to the taxpayer and to such organization, and (3) that portion of dues

with respect to any organization of which the taxpayer is a member which is attributable to the expenses of the activities above described in this paragraph which are carried on by such organization. Paragraph (1) also provides that the expenses referred to therein are to include, but not be limited to, the cost of preparing testimony and traveling expenses described in subsection (a)(2) of section 162.

Paragraph (2) of the new subsection (e) provides that the provisions of paragraph (1) are not to be construed as allowing the deduction of any amount paid or incurred (whether by way of contribution, gift, or otherwise)—

(1) for participation in, or intervention in, any political campaign on behalf of any candidate for public office, or

(2) in connection with any attempt to influence the general public, or segments thereof, with respect to legislative matters, elections, or referendums.

(*b*) *Effective date.*—Subsection (b) of section 3 of the bill provides that the amendments made by subsection (a) are to apply to taxable years beginning after December 31, 1962.

SECTION 4. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES

(*a*) *Denial of deduction.*—Subsection (a) of section 4 of the bill adds to part IX of subchapter B of chapter 1 of the code (relating to items not deductible in computing taxable income) a new section 274.

SECTION 274. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES

Section 274 provides generally that certain expenses deductible in full under present law will be partially or completely disallowed for purposes of chapter 1 of subtitle A. Since section 274 is a disallowance provision exclusively, no expense would become deductible by reason of its enactment. In other words, the tests for deductibility under provisions of existing law (such as secs. 162, 165, 167 and 212) must first be met before the provisions of section 274 become operative. In addition, subsection (c) (relating to substantiation) of the new section 274 must be applied before determining the extent to which an expense or other item is disallowed under subsection (a) or (b) of section 274.

(*a*) *Entertainment, amusement, or recreation.*—

Activity.—Paragraph (1)(A) of subsection (a) of new section 274 provides that no deduction otherwise allowable under chapter 1 of the 1954 Code is to be allowed for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes that the item was directly related to the active conduct of his trade or business. Such deduction in no event is to exceed the portion of such item directly related to the active conduct of the taxpayer's trade or business.

Examples of "entertainment, amusement, or recreation" are entertaining guests at night clubs, country clubs, theaters, football games, and prizefights, and on hunting, fishing, vacation, and similar trips. In addition, "entertainment" includes satisfying the personal, living,

or family needs of any individual (which would otherwise constitute a business expense to the taxpayer) such as the furnishing of food and beverages, a hotel suite, or an automobile. By referring to an activity which "is of a type generally considered to constitute" entertainment, amusement, or recreation, the subsection provides an objective test for determining whether an activity falls within the proscribed category. This test makes irrelevant such arguments as, e.g.—that an essentially recreational activity, like sailing a yacht, is hard work and not recreation insofar as any particular taxpayer is concerned.

However, the taxpayer's business is to be considered in applying this objective test. For example, with respect to a taxpayer who is a professional hunter, a hunting trip generally would not be considered a recreation-type activity. On the other hand, with respect to a taxpayer whose trade or business consists of selling machine tools, manufacturing clothing, or rendering legal services, a hunting trip generally would be considered a recreation-type activity.

To further illustrate this objective test, a theatrical performance generally would be considered, with respect to most taxpayers, an entertainment-type activity. In the case of a professional theater critic, however, viewing a theatrical performance generally would not be considered to constitute entertainment. Another example of the role played by the taxpayer's business in determining the type of an activity would be in connection with a fashion show. If the taxpayer conducting the fashion show is the manufacturer of the dresses shown and the viewers are a group of store buyers, the show generally would not be considered to constitute entertainment, because the fashion show is, for a dress manufacturer, a method for introducing his product to the market. However, if the taxpayer conducting the fashion show is an appliance distributor and the viewers are the retailers and their wives, the fashion show generally would be considered to constitute entertainment.

An exception to the disallowance of entertainment-type expenses is made in paragraph (1)(A) for expenses therein described which the taxpayer establishes are directly related to the active conduct of his trade or business. Among other things, the taxpayer will have to show more than a general expectation of deriving some income at some indefinite future time from the making of the entertainment-type expenditure. However, a taxpayer will not be required to show that income actually resulted from each and every expenditure for which a deduction is claimed.

If the expenditure is for entertainment which occurs under circumstances where there is little or no possibility of conducting business affairs or of carrying on negotiations or discussions relating thereto, the expenditure generally will not be considered to be directly related to the active conduct of business. Thus, the absence of the taxpayer or his representative from the entertainment activity ordinarily indicates that the entertainment is not directly related to the active conduct of the taxpayer's trade or business. Similarly, if the group of persons entertained is large or the distractions substantial, the cost of the entertainment will not be deductible, in the absence of a showing of a direct relationship to the active conduct of the business. All the facts and circumstances pertaining to the entertainment activity will be considered in this connection. Thus, expenses incurred for a "hos-

pitality room", at a convention, at which goodwill is created through display or discussion of the taxpayer's products, will be treated as directly related.

Where a taxpayer's trade or business consists of promoting the interest of another person—such as an independent sales agent for a manufacturer, a public relations corporation, an attorney representing a client, or an employee representing his employer—an expense for an entertainment-type activity made with respect to promoting such other person's interest will not come within the exception for expenses directly related to the active conduct of a trade or business unless the taxpayer establishes the same close connection between the expenditure and such other person's trade or business or other income-producing activity as such other person would have to establish in order to come within the exception. Thus, to come within the exception, it clearly will not suffice for such taxpayer to establish that the making of such expenditure was necessary in order to enable him to continue in the service of such other person.

Paragraph (1) further provides that a deduction for an item with respect to entertainment-type activities is not to exceed the portion of such item directly related to the active conduct of the taxpayer's trade or business. This provision permits apportionment of an expense as between its business-connected and personal aspects according to objective standards.

Facilities.—Paragraph (1)(B) of subsection (a) of new section 274 provides that no deduction otherwise allowable under chapter 1 of the code is to be allowed for any item with respect to a facility used in connection with an activity generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes (1) that the facility was used primarily for the furtherance of his trade or business, and (2) that the item was directly related to the active conduct of his trade or business. Such deduction in no event is to exceed the portion of such item directly related to the active conduct of the taxpayer's trade or business. The same tests for determining whether an item is directly related to the active conduct of a trade or business apply as in the case of an item under paragraph (1)(A).

The term "facility" includes any item of personal or real property owned or rented by the taxpayer, such as a yacht, hunting lodge, fishing camp, swimming pool, tennis court, bowling alley, automobile, airplane, apartment, hotel suite, dining room, and cafeteria. In addition to the items more commonly regarded as "expenses" for entertaining, discussed above, paragraph (1)(B) also relates to other items, such as depreciation and losses realized on certain sales.

Under paragraph (1)(B), in addition to the requirement that the item be directly related to the active conduct of the taxpayer's trade or business, the facility must be used primarily for the furtherance of the taxpayer's trade or business. Thus, if a facility is used more than one-half for business entertaining, so that more than one-half of the entertainment expense with respect to such facility would be deductible as a business expense under present law, that portion is still to be deductible to the extent it meets the test of being directly related to the active conduct of the taxpayer's trade or business. If less than one-half of such entertainment expense would be deductible under present law, no deduction is to be allowed. In connection with these

determinations, objective rather than subjective standards are to be employed.

Paragraph (2) of subsection (a) of new section 274 prescribes two special rules for purposes of applying paragraph (1). All dues and fees paid to any social, athletic, or sporting club or organization will be treated as items with respect to a facility used for entertaining. Thus, only if the taxpayer uses a country club to which he belongs primarily for the furtherance of his business will a deduction be allowed for dues or fees paid to such club, and then only to the extent that such use is directly related to the active conduct of his business. In addition, in applying paragraph (1) an activity described in section 212 (relating to expenses for the production of income) is to be treated as a trade or business.

(*b*) *Gifts.*—Generally, subsection (b)(1) of new section 274 disallows all expenses for gifts to individuals in excess of a cumulative total of $25 per year per recipient. The reference to "indirect" gifts in this subsection includes situations where the gift is intended for the eventual use or benefit of an individual but is made initially to his corporation or to some member of his family. The term "gift", for purposes of section 274, has the same meaning as it does under section 102 of the code (relating to the exclusion of gifts and inheritances from gross income).

Any item which is excludable from gross income under a provision of chapter 1 of the code other than section 102 is not a "gift" within the meaning of subsection (b)(1). To illustrate the applicability of subsection (b)(1), a payment by an employer to a deceased employee's widow which is excludable from her income by reason of the gift exclusion provision, section 102, will not be deductible by the employer in excess of $25, whereas the treatment by an employer of a payment to a deceased employee's widow which constitutes an employee's death benefit excludable by the recipient under section 101(b) of the code will not be affected by this provision. As another example, amounts received by an individual as a scholarship which are excludable from the individual's gross income under section 117 of the code are not "gifts" within the meaning of this subsection. Similarly, those prizes and awards which are excludable from an individual's gross income under section 74(b) of the code are not "gifts" within the meaning of this subsection.

Since the question in subsection (b)(1) is what portion of the taxpayer's expense will be disallowed, the $25 amount necessarily relates to the taxpayer's cost rather than to the value of the property to the donee. However, certain incidental costs, such as packaging, insurance, and mailing or other delivery, will be disregarded in determining whether the $25 limit has been exceeded.

There is a possibility of overlapping application of subsections (a) and (b), since some items can reasonably be classified both as gifts and as entertainment. Different rules under section 274 apply depending on the classification of the item. As described in greater detail below, the express authority given to the Secretary of the Treasury or his delegate to prescribe regulations will be used to solve these problems of classification so as to clarify and make more certain the application of section 274.

Subsection (b)(2) prescribes two special rules for applying subsection (b)(1). Under subsection (b)(2)(A), in the case of a gift by a

partnership (including a gift made by a partner with respect to the business of the partnership), the $25 limitation will be applied at the partnership level, as well as at the level of the individual partner. Thus deductions for gifts made with respect to partnership business will not exceed $25 per recipient, regardless of the number of partners.

Under subsection (b)(2)(B), a husband and wife are for purposes of subsection (b)(1) treated as one "taxpayer". Thus, in the case of a gift by a husband and wife, the spouses will be treated as one donor. However, since "taxpayer" in subsection (b)(1) refers only to the donor of a gift, this special rule does not pertain to gifts, for example, made by an individual to a husband and wife who are partners in a business.

(*c*) *Substantiation required.*—Subsection (c) of the new section 274 imposes another limitation on traveling expenses deductible under section 162(a)(2) or 212, on items with respect to activities described in subsection (a) as entertainment, amusement, or recreation, or with respect to facilities used in connection therewith (whether or not excepted from the application of subsec. (a) of sec. 274 by subsec. (d)), and on expenses for gifts. Subsection (c) overrules with respect to the described expenditures the case of *Cohan* v. *Commissioner*, 39 F. 2d 540 (C.A. 2d 1930). That case held that where evidence indicates that a taxpayer has incurred deductible travel or entertainment expenses but their exact amount cannot be determined, the court must make "as close an approximation as it can" and not disallow the deduction entirely. Under subsection (c) approximations of the type which under the *Cohan* doctrine have been sufficient to entitle the taxpayer to a deduction will no longer have that effect. In other words, if the taxpayer fails to substantiate an item as required by subsection (c) and the regulations thereunder, the item will be completely disallowed.

Subsection (c) provides that no deduction is to be allowed for the above-described items unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his own statement the following: the amount of such expense or other item; the time and place of the travel, entertainment, amusement, recreation, or use of the facility, or the date and description of the gift; the business purpose of the expense or other item; and the business relationship to the taxpayer of the persons entertained, using the facility, or receiving the gift. The taxpayer's records or corroborating evidence must pertain to separate expenses or other items of deduction, not to aggregate amounts.

Generally, a clear, contemporaneously kept diary, account book, or similar record containing the information specified in subsection (c) will be an adequate record within the meaning of this subsection. However, receipts, cancelled checks, paid bills, stubs, or other similar records may be required in certain cases, as, for example, to substantiate the amount expended for lodging and transportation while traveling on business. Thus, the taxpayer may be required to preserve hotel bills or transportation receipts to substantiate such items by adequate records. In order to avoid hardship, a reasonable reconstruction of expenditures will be accepted in those cases where the absence of records is due to circumstances beyond the taxpayer's control, such as destruction by fire, flood, or other casualty.

Where the taxpayer fails to maintain adequate records with respect to any of the described aspects of an expense, that aspect must be substantiated by the taxpayer's own statement corroborated by sufficient evidence. The taxpayer's own uncorroborated statement will not constitute substantiation with respect to any such aspect. The evidence required may vary with respect to each aspect of an item claimed as a deduction. Thus, circumstantial evidence, such as the nature of the business activities of the taxpayer and of the person entertained, may be sufficient to corroborate the taxpayer's statement regarding business purpose and business relationship, whereas more direct evidence, such as the testimony of witnesses, will be required to substantiate amount, time, place, date and description.

Under subsection (c), the Secretary of the Treasury or his delegate is authorized to provide by regulations that some or all of the requirements of subsection (c) are not to apply in the case of an expense which does not exceed an amount determined under such regulations. Thus, the regulations could provide that a fixed scale of allowance for mileage or per diem in lieu of subsistence based upon reasonable business practices, will be acceptable in lieu of detailed substantiation. Similarly, the regulations could prescribe an exception for *de-minimis* expenses.

(*d*) *Exceptions to application of subsection* (*a*).—Subsection (d) of the new section 274 contains nine exceptions to the general rule of section 274(a). These exceptions are to the disallowance provision of subsection (a) exclusively. The fact that an item is not covered by one of the nine exceptions does not mean that *ipso facto* it will be disallowed under subsection (a). It is to be emphasized that the new section 274(d) in no way changes existing law with respect to the disallowance of expenses by reason of failure to meet the "ordinary and necessary" test in section 162 or 212 of the code. Furthermore, the substantiation requirements of subsection (c) also must be fulfilled with respect to the items covered by these exceptions.

Paragraph (1) excepts from the disallowance prescribed in subsection (a)(1) expenses for food and beverages furnished under circumstances which are of a type generally considered to be conducive to a business discussion, taking into account the surroundings in which furnished, the taxpayer's trade, business, or income-producing activity, the relationship to such trade, business, or activity of the persons to whom the food and beverages are furnished, and any other relevant facts. There is no requirement in this exception that business actually be discussed. Thus, if the described circumstances are established, and if the amounts are deductible under section 162 or 212 and are substantiated as required under section 274(c), the expenses for food and beverages will be deductible even where the making of the expenditure merely promotes goodwill.

Generally, a night club or other place where entertainment is a major attraction would not be considered a suitable environment for a business discussion. Similarly, any sizable social gathering, such as a large cocktail party, would afford little opportunity for quiet business talk and ordinarily would not be considered circumstances conducive to a business discussion. However, a dinner which is part of a formal business program will generally be regarded as a circumstance conducive to a business discussion.

Paragraph (2) relates to food and beverages furnished on the taxpayer's business premises. By reason of this exception, no expense for food and beverages furnished on the business premises primarily to employees of the taxpayer will be disallowed under section 274(a). In addition, expenses for food and beverages furnished to nonemployee business guests will be deductible if furnished in a dining room which is primarily for the taxpayer's employees and is located on the taxpayer's business premises. Paragraph (2) also excepts from disallowance expenses for facilities to the extent they are used in connection with furnishing the above-described food and beverages. The exception provided by paragraph (2) applies to both the typical company cafeteria and meals furnished to employees because their presence on the job at all times is essential.

The exception in paragraph (3) applies to expenses for goods, services and facilities to the extent that the expense is properly treated by the taxpayer, with respect to the recipient of the entertainment, amusement, or recreation, as compensation paid to an employee on the taxpayer's income tax return and as "wages" for purposes of withholding. Thus, a taxpayer rewarding a key employee with a vacation trip would not be disallowed the expenses under section 274(a) if the taxpayer treated the expenses as wages for withholding purposes and deducted them on his income tax return as compensation paid to the key employee. Salary paid to the captain of a yacht used for business entertaining does not come within this exception.

If an expense properly constitutes a dividend to a shareholder, or if it constitutes unreasonable compensation to an employee, the exception in paragraph (3) will not prevent its disallowance.

Paragraph (4) excepts from disallowance with respect to the taxpayer certain expenses paid or incurred by the taxpayer in connection with the performances by him of services for another person (whether or not such other person is the taxpayer's employer) for which the taxpayer is reimbursed by such other person under a reimbursement or other allowance arrangement. This exception prevents the double disallowance of a single expenditure, once with respect to the person who actually bears the expense and benefits from it and once with respect to the person who pays the expense on behalf of the first person and is reimbursed therefor. However, two qualifications are provided which insure that a described expense will be disallowed at one level. If the services are performed by a taxpayer, who is an employee, for his employer, and if the employer treats the expense as compensation paid to the employee and it falls within the scope of the subsection (d)(3) exception, the subsection (d)(4) exception does not apply. If the services are performed by the taxpayer for a person who is not the taxpayer's employer, the subsection (d)(4) exception does not apply unless the taxpayer accounts to such other person by means of records or other sufficient evidence which would satisfy the substantiation requirement of subsection (c). The term "reimbursement or other expense allowance arrangement" is derived from section 62(2)(A) of the code and has the same meaning in section 274(d) (without regard to whether the taxpayer is the employee of the person for whom services are performed) as it does in that section.

Paragraph (5) provides an exception for expenses for recreational, social, or similar activities which are primarily for the benefit of the

employees of the taxpayer. This exception applies to the usual employee fringe benefit programs. For example, the expenses of operating a company bowling alley or swimming pool which is available to all employees generally will be deductible. Similarly, the costs of the office Christmas party or summer outing generally will be deductible.

In order to exclude from this exception benefits primarily for executives and owners of closely held businesses, the exception applies only with respect to activities which are primarily for employees other than employees who are officers, shareholders, or other owners who own a 10-percent or greater interest in the business, or highly compensated employees. In determining whether an employee owns a 10 percent or greater interest in the business, the employee is to be treated as owning any interest owned by a member of his family (within the meaning of sec. 267(c)(4)).

Paragraph (6) provides an exception for expenses directly related to business meetings of employees or stockholders. This exception pertains only to meetings which are principally for the discussion of business. To illustrate, a meeting of employees for the principal purpose of introducing them to and instructing them with respect to a new procedure for conducting the employer's business would be considered a business meeting. Similarly, a regular annual meeting of stockholders for the election of directors and discussion of corporate affairs would be considered a business meeting. A convention of employees for the principal purpose of rewarding them for their outstanding performance of services for their employer would not be considered a business meeting. However, such a convention might come within the scope of paragraph (3) or (5).

Paragraph (7) pertains to expenses directly related and necessary to attendance at business meetings or conventions of exempt section 501(c)(6) organizations. It is similar to the exception in paragraph (6), except that it relates only to attendance at meetings, or conventions of business leagues, chambers of commerce, real-estate boards, or boards of trade which are exempt from tax under section 501(a) and it is not limited in application to attendance by employees or stockholders.

Paragraph (8) pertains to goods and services (including the use of facilities) which are made available by the taxpayer to the general public. By reason of this exception, expenses for entertainment of the general public by means of television, radio, newspapers, and the like will continue to be deductible under section 162. Similarly, a deduction may still be claimed under section 162 for the expense of maintaining private parks, golf courses, and similar facilities, to the extent that they are available for public use. For example, if a corporation maintained a swimming pool for the use of its executive officers and their guests but during the summer months made the pool available for a period of time each week to the children participating in the local public recreation program, the portion of the expenses relating to such public use of the pool would come within this exception.

Paragraph (9) is designed to insure that no expense will be disallowed under subsection (a) if it is for goods or services which are sold by the taxpayer in a bona fide transaction for an adequate and full consideration in money or money's worth. Thus, the cost of producing night club entertainment for sale to customers will not be

disallowed. Similarly, the cost of operating a pleasure cruise ship as a business will not be disallowed.

The last sentence in subsection (d) makes it clear that the "expenses" to which paragraphs (1) through (9) relate include such items as depreciation and losses.

(*e*) *Interest, taxes, casualty losses, etc.*—Subsection (e) excepts from the provisions of section 274 items which would constitute allowable deductions for an individual taxpayer regardless of whether he was engaged in any trade or business. Examples of such items are interest, taxes such as real property taxes, and casualty losses. Thus, if a taxpayer owned a fishing camp, he could still deduct mortgage interest and real property taxes in full even if its use was not primarily for the furtherance of the taxpayer's trade or business.

(*f*) *Treatment of entertainment, etc., type facility.*—This subsection prescribes the treatment to be accorded facilities coming within the purview of subsection (a)(1)(B), for purposes of chapter 1 generally. To the extent that expenses and other items with respect to a facility are disallowed under subsection (a), that portion of the facility is to be accorded the treatment provided under present law to an asset used exclusively for personal, living, and family purposes. Thus, the portion of a facility so treated will not be subject to depreciation, and losses incurred on the sale of such portion will not be deductible.

(*g*) *Regulatory authority.*—Subsection (g) authorizes the Secretary of the Treasury or his delegate to prescribe such regulations as he deems necessary to carry out the purposes of section 274. For example, under this authorization rules will be prescribed for determining whether subsection (a) or subsection (b) applies to an expenditure to which both subsections might be considered to apply. Items are to be given the character ascribed to them by the public generally and without regard to the revenue consequences of the characterization. In addition, the Secretary of the Treasury or his delegate is required to prescribe rules for determining whether section 274 (a) or (b) applies with respect to an expenditure which could also be described as falling solely within the purview of some other section. This overlap problem will be resolved by ascribing to the expenditure a character which carries out the purposes of section 274. If the item confers a personal benefit in the form of entertainment, amusement, recreation or a personal, living or family need of the individual it will be treated as a section 274 item.

The problem of the overlap of subsections (a) and (b) of section 274 can be illustrated by a case where a taxpayer provides one of his customers with tickets to an amusement event. Here both the entertainment and gift provisions might apply. Under the regulations the entertainment provision always will apply with respect to such theater tickets regardless of whether the taxpayer accompanies the customer to the theater or sends him the tickets. On the other hand, gifts of a chattel such as a book or a toy will be classified as a gift, coming within the purview of subsection (b), even though the use of the item results in the entertainment of the recipient. Packaged food and beverages will be treated as gifts, while food and beverages consumed at meals will be considered entertainment.

The problem of properly characterizing an expenditure for purposes of determining whether section 274 is applicable, or whether the expenditure is to be treated solely under some other section, can be illustrated by a case where a taxpayer distributes to each of his cus-

tomers a valuable gift which is inscribed with the taxpayer's name. Expenditures for such items might be characterized as advertising expenses or as expenses for gifts. Under the regulations, expenditures for such items will be characterized as gifts.

SECTION 4. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES (Continued)

(*b*) *Traveling expenses.*—Subsection (b) of section 4 of the bill amends section 162(a)(2) of the 1954 Code (relating to traveling expenses while away from home) by striking out the existing provision under which the entire amount expended for meals and lodging is included in the allowable deduction and substituting therefor a provision under which there is to be included a reasonable allowance expended for meals and lodging.

(*c*) *Effective date.*—Subsection (c) of section 4 of the bill provides that the amendments made by section 4 are to apply with respect to taxable years ending after June 30, 1962, but only with respect to periods after such date.

SECTION 5. AMOUNT OF DISTRIBUTION WHERE CERTAIN FOREIGN CORPORATIONS DISTRIBUTE PROPERTY IN KIND

(*a*) *Amount distributed.*—Subsection (a) of section 5 of the bill amends section 301(b)(1) (relating to amount distributed to corporate distributees) of the 1954 Code by adding at the end thereof a new subparagraph (C). The general rule in new subparagraph (C) provides that for purposes of section 301 the amount of a distribution of property (other than money) received by a corporate shareholder from a foreign corporation will be the fair market value of such property.

An exception to the general rule is provided in cases where a dividends received deduction is allowable under section 245 with respect to such a distribution. In such a case, the amount to be taken into account (for purposes of sec. 301 of the code) with respect to property other than money is the sum, determined under regulations prescribed by the Secretary of the Treasury or his delegate, of the amounts computed under subparagraphs (C)(i) and (C)(ii). The amount under subparagraph (C)(i) is that proportion of the lesser of—

(1) the fair market value of such property, or

(2) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of such property,

which is properly attributable to gross income from sources within the United States. The amount under subparagraph (C)(ii) is that proportion of the fair market value of such property which is properly attributable to gross income from sources without the United States.

The application of subparagraph (C) may be illustrated by the following example involving corporation X, a domestic corporation which owns 100 percent of the outstanding stock of corporation Y, a foreign corporation. Corporation Y, which makes its return on the basis of the calendar year, has earnings and profits of $200,000 for 1963 and derives 60 percent of its gross income from sources within the

United States during 1963. For an uninterrupted period of 36 months ending with the close of 1963, corporation Y has been engaged in trade or business within the United States and has derived 50 percent or more of its gross income from sources within the United States. Assume that the only distribution made by corporation Y during 1963 is a distribution of property which has a fair market value of $100,000 and an adjusted basis (in the hands of the distributing corporation immediately before the distribution) of $40,000. The amount of the distribution of such property as determined under section 301(b)(1)(C) is $64,000, computed as follows:

(1) Amount computed under section 301(b)(1)(C)(i): That proportion of the adjusted basis of such property (since it is less than the fair market value) which is properly attributable to gross income from sources within the United States, that is, adjusted basis multiplied by the ratio which gross income from sources within the United States bears to gross income from all sources. $40,000×60 percent	$24,000
(2) Amount computed under section 301(b)(1)(C)(ii): That proportion of the fair market value of such property which is properly attributable to gross income from sources without the United States, that is, fair market value multiplied by the ratio which gross income from sources without the United States bears to gross income from all sources. $100,000×40 percent	40,000
(3) Amount of distribution of property for purposes of section 301	64,000

(*b*) *Basis.*—Subsection (b) of section 5 of the bill amends section 301(d) of the code (relating to basis of property) by adding a new paragraph (3). The new paragraph (3) provides that where the amount of a distribution of property other than money is determined in accordance with the provisions of subparagraph (C) of section 301(b)(1), the basis of such property shall be the amount of the property distribution. Thus, in the above example the property distributed would have a basis in the hands of corporation X, the distributee, of $64,000, the amount of the distribution.

(*c*) *Dividends received from certain foreign corporations.*—Paragraph (1) of subsection (c) of section 5 of the bill amends section 245 of the 1954 Code (relating to dividends received from certain foreign corporations) by adding a new subsection (b). The new subsection (b) provides that for purposes of computing the dividends received deduction under section 245(a) the amount of any distribution of property other than money shall be determined under section 301(b)(1)(B). Under section 301(b)(1)(B) the amount of a distribution of property to a corporate shareholder is the lesser of (1) the fair market value of such property, or (2) the adjusted basis of such property (in the hands of the distributing corporation immediately before the distribution). Thus, for purposes of section 245, the amount of the dividend in the above example would be $40,000, rather than $64,000, and the amount allowed as a deduction under section 245 would be $20,400 ($40,000×60%×85%).

Paragraph (2) of subsection (c) of section 5 of the bill amends section 245 of the 1954 Code so as to designate the existing text as subsection (a) of section 245.

(*d*) *Credit for foreign taxes.*—Subsection (d) of section 5 of the bill amends section 902(a) of the 1954 Code (relating to credit for foreign taxes) to provide that for purposes of section 902 (a) and (b) the amount of any distribution in property other than money shall be

determined under section 301(b)(1)(B). Under section 301(b)(1)(B) the amount of a distribution of property to a corporate shareholder is the lesser of (1) the fair market value of such property, or (2) the adjusted basis of such property (in the hands of the distributing corporation immediately before the distribution). Thus, for purposes of section 902(a) the amount of the dividend in the above example would be $40,000, rather than $64,000.

(*e*) *Effective date.*—Subsection (e) of section 5 of the bill provides that the amendments made by section 5 of the bill shall apply to distributions made after December 31, 1962.

SECTION 6. AMENDMENT OF SECTION 482

(*a*) *In general.*—Subsection (a) of section 6 of the bill amends section 482 of the 1954 Code (relating to allocation of income and deductions among taxpayers) by adding a new subsection (b) relating to sales and purchases within a related group which includes a foreign organization.

Sales and purchases within a related group which includes a foreign corporation—in general

Paragraph (1) of the new section 482(b) provides authority for the Secretary of the Treasury or his delegate to allocate taxable income, arising from sales or purchases of tangible property within a group, which is owned or controlled directly or indirectly, by the same interests and which includes one or more foreign organizations, as well as one or more domestic organizations. New section 482(b) does not apply where an arm's length price can be established for the sales of tangible property. However, it is incumbent upon the taxpayer to establish that the sales price was an arm's length price.

An example of the type of sale which could be dealt with under section 482(b) is as follows: A domestic parent sells articles to a foreign subsidiary where there are not sufficient sales of similar goods to establish an arm's length price. The foreign subsidiary sells the articles to another subsidiary which, in turn sells them to an unrelated organization. In such a situation the Secretary of the Treasury or his delegate could, under section 482(b), allocate, among the members of the group, the total taxable income of the entire group arising out of these sales transactions down to and including the ultimate sale to an unrelated buyer.

Methods of allocation

Paragraph (2)(A) of section 482(b) indicates the factors which the Secretary of the Treasury or his delegate is to take into consideration in making any allocation under such paragraph (2)(A). These factors are specifically enumerated in clauses (i)—(iii).

Clause (i) refers to assets of the group (which are further specified in par. (3)) to the extent used in the production, distribution, and sale of the articles. Clause (ii) refers to compensation of officers and employees, to the extent attributable to the production, distribution, and sale of the articles. Compensation includes salaries and wages and such other elements of compensation as may be definitely associated with the salary and wages so attributable. Clause (iii) refers to advertising, selling, and sales promotion expenses (including technical and servicing expenses), to the extent attributable to the articles.

Paragraph (2)(A) contemplates first determining that portion of any asset or item of expense which is attributable to the articles sold. In applying the enumerated factors to this portion, the following rules will generally apply—

(1) assets will be taken into account on the basis of situs (within or without the United States) and without regard to which organization owns or leases such assets;

(2) salaries and other compensation will be taken into account on the basis of the area (within or without the United States) in which the services attributable to these articles are performed; and

(3) advertising, selling, and sales promotion expenses will be taken into account on the basis of the location (within or without the United States) of the purchasers and potential purchasers with respect to which such expenses are paid or incurred.

The Secretary of the Treasury or his delegate may take into account other factors, including an allowance for special risks of the market in which the articles are sold.

Section 482(b)(2)(B) provides for the use of an alternative method of allocation if the Secretary of the Treasury or his delegate is satisfied that the taxpayer has established that such other method clearly reflects the income of each member.

Special rules

Paragraph (3) of subsection (b) provides that in considering the factor of assets, the values to be assigned to those assets are their adjusted basis in the hands of the taxpayer. If the adjusted basis of an asset is not determinable in the case of a foreign organization, then book value, adjusted to approximate adjusted basis, will be used.

The assets which are to be considered are real property and tangible personal property (whether owned or leased by a member of the group). Inventory and stock in trade are to be excluded from such consideration.

Arm's length price defined

Section 482(b)(4) provides two methods by which the group may establish the existence of an arm's length price. If an arm's length price is established, the new subsection 482(b) does not apply. However, if the arm's length price so established is not the price at which the sales took place, there may be an allocation of income, deductions, etc., under section 482(a). Under subparagraph (A) of section 482(b)(4), the taxpayer may establish an arm's length price as the identifiable price at which tangible personal property, which is similar or comparable to the property sold by such taxpayer, can be sold, or is actually sold, in the same market areas in transactions involving unrelated persons and under similar conditions of sale. For this purpose, the same market area refers to a geographic area, without regard to political boundaries, in which the same market conditions prevail and where it could be expected that prices would be the same. The requirement as to similar conditions of sales means that there should not be excluded from the one sale, and included in the other any circumstance, such as a longer warranty, which would normally have an appreciable influence on the price if included or excluded.

Subparagraph (B) of section 482(b)(4) provides that if it is not possible to establish a price in this manner, then an arm's length price

may still be established if it is possible to adjust the prices at which tangible property similar or comparable to the property referred to above is sold in the same or other areas under similar circumstances and in transactions involving unrelated persons. The adjustments should include those for material differences in quantity, marketing conditions (including customs duty and transportation costs), and other relevant factors. The utilization of this method is limited to situations in which the required adjustments can be properly determined.

An example of the establishment of an arm's length price under subparagraph (B) is the following: Taxpayer A sells product M in country X to a controlled subsidiary, and in country Y A sells a comparable product N to unrelated parties. It is established that the differences between products N and M are of a type which would not ordinarily involve a price differential; the quantity of product M sold to the subsidiary would ordinarily involve a 2% discount over the quantity of product N sold to unrelated parties in country Y; such sales in Y include a warranty not afforded in X, but worth 5% of the sales price; and countries X and Y are areas involving similar market conditions. If all the preceding assumptions are properly determinable by external facts (such as arm's length transactions), the appropriate arm's length price for these sales to the subsidiary in X can be established by reference to these sales in Y.

Sales commissions

Paragraph (5) of the new section 482(b) gives the Secretary of the Treasury or his delegate the authority to allocate commissions arising from sales or purchases of tangible property within the group in the same manner as sales income. The application of section 482(b) to such commission income is to be accomplished under rules contained in regulations prescribed by the Secretary of the Treasury or his delegate, which rules shall be consistent with principles applying under such section to income from sales of tangible property.

Grossly inadequate assets, etc., outside the United States

Paragraph (6) of the new section 482(b) provides that no taxable income is to be allocated to a foreign organization whose assets, personnel, office and other facilities located outside the United States are grossly inadequate for its activities outside the United States. Under such circumstances the total taxable income of the group would be allocated to members other than such organization.

Information necessary for consideration of factors

Paragraph (7) of the new section 482(b) provides that where the allocation referred to in paragraph (2)(A) is involved and where the information submitted with respect to the group is insufficient for such allocation, then if, after a request is made to the group for additional information which may reasonably be supplied, the group fails to supply such additional information, the Secretary of the Treasury or his delegate may estimate the taxable income arising from the particular transaction and allocate such estimated income within the group or to any single member thereof.

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Treatment of foreign taxes

Paragraph (8)(A) provides that in making the allocation under section 482(b), taxable income is to be computed without any deduction for any income, war profits, or excess profits taxes paid to any foreign country or United States possession.

Subparagraph (B) of paragraph (8) provides that if the application of section 482(b) results in reducing the taxable income of any foreign organization within the group and in increasing the taxable income of a domestic member of such group, then that portion of the taxes referred to in subparagraph (A) paid by the foreign organization, which is attributable to the income transferred pursuant to such allocation to the domestic member, will be considered as paid by the domestic organization (and as not paid by the foreign organization). Whether such taxes are deducted or credited by the domestic organization would depend on the overall circumstances of that organization.

(*b*) *Clerical amendment.*—Subsection (b) of section 6 of the bill is a clerical amendment the effect of which is to designate the text of existing section 482 as subsection (a) of section 482.

(*c*) *Effective date.*—Subsection (c) of section 6 of the bill provides that the amendments made by section 6 of the bill are to apply with respect to taxable years beginning after December 31, 1962.

SECTION 7. DISTRIBUTION OF FOREIGN PERSONAL HOLDING COMPANY INCOME

(*a*) *Definition of foreign personal holding company.*—Section 552(a) of the 1954 Code now defines the term "foreign personal holding company" to mean any foreign corporation if—

(1) at any time during the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals who are citizens or residents of the United States (referred to as a "United States group"); and

(2) at least 60 percent of its gross income for the taxable year is foreign personal holding company income.

However, if the corporation is a foreign personal holding company with respect to any taxable year, then, for each subsequent taxable year, the minimum percentage is 50 percent in lieu of 60 percent until a taxable year during the whole of which the stock ownership referred to in paragraph (1) does not exist or until the expiration of 3 consecutive taxable years in each of which less than 50 percent of the gross income is foreign personal holding company income.

Subsection (a) of section 7 of the bill amends section 552(a) of the 1954 Code so as to substitute for the gross income requirements referred to above a new rule that a foreign corporation satisfies the gross income requirement if at least 20 percent of its gross income for the taxable year is foreign personal holding company income.

(*b*) *Amount of undistributed income.*—Section 556(a) of the 1954 Code now defines the term "undistributed foreign personal holding company income" to mean the taxable income of the foreign personal holding company with certain modifications (including a deduction for Federal income taxes and for dividends paid).

Subsection (b) of section 7 of the bill amends section 556(a) so as to retain, in effect, the existing definition where the foreign personal holding income of the foreign personal holding company exceeds 80

percent of its gross income, and to provide that where the foreign personal holding company income does not exceed 80 percent of its gross income, the "undistributed foreign personal holding company income" is to be an amount which bears the same ratio to—

(1) the amount of taxable income (computed and adjusted as under existing law), as

(2) its foreign personal holding company income bears to its gross income.

The amendments made by section 7 of the bill may be illustrated by the following example:

Assume that C, a United States citizen, wholly owns F, a foreign corporation. F has not been a foreign personal holding company for any prior taxable year. For the taxable year F has gross income of \$100 (which includes \$50 of foreign personal holding company income), has deductions under section 556(b) of \$10 (and no other adjustments under section 556(b)), and pays a dividend of \$5. F's taxable income (adjusted as provided in section 556(b)) is \$90. Under existing law, F is not a foreign personal holding company. Under the bill, F is a foreign personal holding company and has undistributed foreign personal holding company income of

$$\$42.50\left(\frac{50}{100}\times(\$90-\$5)=42.50\right).$$

(c) *Effective date.*—Subsection (c) of section 7 of the bill provides that the amendments made by section 7 are to apply only in respect of taxable years of foreign corporations beginning after December 31, 1962.

SECTION 8. MUTUAL SAVINGS BANKS, ETC.

(*a*) *In general.*—Subsection (a) of section 8 of the bill amends section 593 of the 1954 Code to provide a new method for calculating the deduction for additions to bad debt reserves allowable to the mutual savings banks, domestic building and loan associations, and cooperative banks, referred to in section 593(a) (all of which are hereinafter referred to as mutual savings institutions).

SECTION 593. RESERVES FOR LOSSES ON LOANS

(*a*) *Organizations to which section applies.*—Subsection (a) of section 593, as amended by the bill, provides that section 593 is to apply to any mutual savings bank not having capital stock represented by shares, domestic building and loan association, or cooperative bank without capital stock organized and operated for mutual purposes and without profit. This description of the organizations to which section 593 of existing law, and no substantive change is made by this change in description. (As is noted below, however, subsec. (c) of sec. 8 of the bill redefines the term "domestic building and loan association".)

(*b*) *Additions to reserves for bad debts.*—Subsection (b)(1) prescribes the method for determining the reasonable addition for the taxable year to the reserve for bad debts under section 166(c), and also specifies the reserves to which such additions shall be made. Such reasonable

addition is the sum of two amounts—(1) the amount added to the reserve for losses on nonqualifying loans, and (2) the amount added to the reserve for losses on qualifying real property loans.

The first amount is that determined under section 166(c) to be a reasonable addition to the reserve for losses on nonqualifying loans. Nonqualifying loans are defined in subsection (e)(2), and (with certain exceptions) are loans other than loans secured by an interest in improved real property.

The second amount is the amount determined by the taxpayer to be a reasonable addition to the reserve for losses on qualifying real property loans. However, this amount cannot exceed the amount determined under one of three different methods described in paragraphs (2), (3) and (4) of subsection (b), whichever method produces the largest amount. Qualifying real property loans are defined in subsection (e)(1) and (with certain exceptions) are loans secured by an interest in improved real property.

60 percent of taxable income method

Under this method, which is described in subsection (b)(2), the amount of the reasonable addition to the reserve for losses on qualifying real property loans for a taxable year is limited to the excess of an amount equal to 60 percent of the taxable income for such year over the amount determined under section 166(c) to be a reasonable addition to the reserve for losses on nonqualifying loans. For purposes of this method, taxable income is determined without regard to any deduction under section 166(c) for any additions to the reserves for bad debts, and also by excluding from gross income any amount included therein by reason of subsection (f) (relating to the treatment of certain distributions of property to stockholders by a domestic building and loan association).

3 percent of real property loans method

Under this method, described in subsection (b)(3), the amount of the reasonable addition to the reserve for losses on qualifying real property loans is limited to the amount necessary to increase the balance of such reserve (as of the close of the taxable year) to 3 percent of such loans outstanding at that time.

Experience method

Under this method, described in subsection (b)(4), the amount of the reasonable addition to the reserve for qualifying real property loans is limited to the amount determined under section 166(c) without regard to sec. 593(b)) to be a reasonable addition to such reserve.

(*c*) *Treatment of reserves for bad debts.*—Subsection (c)(1) of section 593 as amended provides that each mutual savings institution which uses the reserve method of accounting for bad debts is to establish and maintain a reserve for losses on qualifying real property loans, a reserve for losses on nonqualifying loans, and a supplemental reserve for losses on loans. Such reserves are to be treated for all purposes as reserves for bad debts. Thus, although these reserves are termed reserves for "losses", they are to be treated as reserves for bad debts; and any charge to any such reserve for an item other than a bad debt will result in the inclusion in gross income of an amount equal to such charge.

Allocation of pre-1963 reserves

Paragraphs (2) and (3) of subsection (c) prescribe rules governing the method of allocating pre-1963 reserves among the three reserves described above. The term "pre-1963 reserves" is defined by paragraph (4) to mean the net amount, determined as of the close of December 31, 1962 (after applying the provisions of subsec. (d)(1) relating to taxable years beginning in 1962 and ending in 1963), accumulated in the reserve for bad debts pursuant to section 166(c) (or the corresponding provisions of prior revenue laws) for taxable years beginning after December 31, 1951. Thus, reserves accumulated by a mutual savings institution in taxable years beginning prior to December 31, 1951, when the institution was a tax-exempt organization, are not included in pre-1963 reserves and are not to be taken into account for purposes of computing the deduction allowable for additions to reserves for bad debts pursuant to section 593 for periods after December 31, 1962.

Paragraph (2) of subsection (c) provides that such pre-1963 reserves shall, as of the close of December 31, 1962, be allocated to, and constitute the opening balances of, the reserve for losses on nonqualifying loans, the reserve for losses on qualifying real property loans, and the supplemental reserve for losses on loans.

Paragraph (3) of subsection (c) provides that the pre-1963 reserves shall be allocated first to the reserve for losses on nonqualifying loans to the extent that such reserve is not increased above the amount which would constitute a reasonable addition under section 166(c) for a period in which such nonqualifying loans increased from zero to the amount thereof outstanding at the close of December 31, 1962. Thus, the pre-1963 reserves will be allocated to the reserve for losses on nonqualifying loans in an amount not in excess of the maximum amount (determined without regard to any annual limitation which might be imposed under sec. 166(c) on building such reserve to its full amount) which could have been added, as of the close of 1962, to such reserve under subsection (b)(1)(A) if the balance of such reserve immediately prior to such addition had been zero. The remaining portion of the pre-1963 reserves is then allocated to the reserve for losses on qualifying real property loans to the extent such reserve is not increased above the larger of two amounts. The first amount is the amount which would be determined under paragraph (3) of subsection (b) as being necessary to increase the balance of the reserve from zero to 3 percent of qualifying real property loans outstanding at the close of December 31, 1962. The second amount is the amount which would be determined under section 166(c) (without regard to sec. 593) to be a reasonable addition to the reserve for losses on qualifying real property loans for a period in which such loans increased from zero to the amount thereof outstanding at the close of December 31, 1962. Any remaining balance of the pre-1963 reserves is allocated to the supplemental reserve for losses on loans.

Subsection (c)(5) provides that any debt becoming worthless or partially worthless in respect of a qualifying real property loan shall be charged to the reserve for losses on such loans, and any debt becoming worthless or partially worthless in respect of a nonqualifying loan shall be charged to the reserve for losses on nonqualifying loans; except that any such debt may, at the election of the taxpayer, be

charged in whole or in part to the supplemental reserve for losses on loans.

(*d*) *Taxable years beginning in 1962 and ending in 1963.*—Subsection (d) of the amended section 593 contains provisions for the computation of taxable income in the case of a taxable year which is a fiscal year beginning in 1962 and ending in 1963. With certain exceptions, the general effective date provision in section 8(f)(1) of the bill makes the amended section 593 applicable with respect to taxable years ending after December 31, 1962. However, subsection (d) makes section 593 take effect with respect to fiscal year taxpayers as of January 1, 1963. Subsection (d) apportions taxable income for the entire taxable year (determined without regard to any deduction under sec. 166(c)) between the part of the taxable year which falls in 1962 and the part which falls in 1963. Such taxable income is allocated to each part year on the basis of the ratio which the number of days in each such part year bears to the number of days in the entire taxable year. The portion of such taxable income allocable to the part of the year occurring before January 1, 1963, is then reduced under subsection (d)(1) by an amount equal to the deduction which would have been allowable under section 166(c) for an addition to the reserve for bad debts as if such part year constituted a taxable year and as if section 593, as in effect before the amendments made by section 8 of the bill, applied. The portion of such taxable income allocable to the part of the taxable year occurring after December 31, 1962, is reduced, under subsection (d)(2), by an amount equal to the deduction for an addition to a reserve for bad debts which would be allowed under section 166(c) (taking into account the amendments made by sec. 8 of the bill) if such part year constituted a taxable year. The amounts of taxable income thus obtained for each part year are then added to obtain the taxable income for the entire taxable year.

The amount of the deduction allowable for the pre-1963 part year to a mutual savings institution under subsection (d)(1) is limited, by reason of section 593(2) of existing law, to the amount by which 12 percent of the total deposits or withdrawable accounts of its depositors at the close of such part year (Dec. 31, 1962) exceeds the sum of its surplus, undivided profits, and reserves at the beginning of the taxable year. In addition, by reason of section 593(1) of existing law, the deduction allowable under subsection (d)(1) for the pre-1963 part year to a mutual savings institution cannot exceed the amount of its taxable income (determined without regard to any deduction under sec. 166) allocable to the pre-1963 part year. Although the amount of the deduction allowable for the pre-1963 part year under subsection (d)(1) cannot be determined until the close of the entire taxable year (by reason of the taxable income limitation and because the amount must be reflected on the institution's regular books of account), this amount is added to the institution's pre-1963 reserves. The pre-1963 reserves are then allocated under the rules of subsection (c), as of the close of December 31, 1962, by reference to the amount of nonqualifying loans and qualifying real property loans outstanding at that time.

The deduction referred to in subsection (d)(2) for the post-1962 part year is determined under subsection (b) and is equal to the sum of the amount of an addition to the reserve for losses on nonqualifying loans plus the amount of an addition to the reserve for qualifying

real property loans. The amount of the addition to the reserve for nonqualifying loans is computed by reference to the amount of such loans outstanding at the close of the taxable year in relation to the balance in the reserve for such loans at that time. The amount of the addition to the reserve for qualifying real property loans, if determined under the 60 percent of taxable income method, would be equal to the excess of an amount equal to 60 percent of the taxable income (determined under subsec. (b)(2)) which is allocable to the post-1962 part year over the amount of the reasonable addition to the reserve for nonqualifying loans. If the addition to the reserve for qualifying real property loans is determined under the 3 percent of real property loans method or the experience method, it would be computed by reference to the amount of such loans outstanding at the close of the taxable year in relation to the balance in the reserve for such loans at that time.

(*e*) *Loans defined.*—Subsection (e) of section 593 defines, for purposes of section 593, the terms "qualifying real property loans", "nonqualifying loans", and "loans".

The term "loan" is defined to mean debt, as the term "debt" is used in section 166. Since subsection (e) of section 166 is made inapplicable by section 582(a) in the case of a mutual savings institution, the term "loan" includes a debt evidenced by a security as defined in section 165(g)(2)(C). For purposes of subsection (e), a taxpayer will be considered to have made a loan to the extent of his participation in the loan, whether the loan was made by him or by another person.

Under paragraph (1) of subsection (e), a "qualifying real property loan" is defined to mean any loan of the taxpayer which is secured by an interest in improved real property unless such loan is described in subparagraph (A), (B), (C), or (D) of such paragraph. The loans described in these subparagraphs are: (A) any loan evidenced by a security (as defined in sec. 165(g)(2)(C)); (B) any loan, whether or not evidenced by a security as defined in section 165(g)(2)(C), the primary obligor on which is a government or political subdivision or instrumentality thereof, a bank as defined in section 581, or another member of the same affiliated group; (C) any loan to the extent secured by a deposit in or share of the taxpayer; and (D) any loan which, within a 60-day period beginning in one taxable year of the creditor and ending in its next taxable year, is made or acquired and then repaid or disposed of, unless the transactions by which such loan was made or acquired and then repaid or disposed of, are established by the taxpayer to be for bona fide business purposes.

The term "affiliated group" is defined as having the meaning assigned to such term by section 1504(a) of existing law; except that (1) the phrase "more than 50%" shall be substituted for the phrase "at least 80%" each place it appears in section 1504(a), and (2) all corporations shall be treated as includible corporations (without any exclusion under sec. 1504(b)).

Paragraph (2) of subsection (e) defines the term "nonqualifying loan" as any loan of the taxpayer which is not a qualifying real property loan as defined by the bill. Thus, a loan which is, for example, evidenced by a security as defined in section 165(g)(2)(C), is treated as a nonqualifying loan irrespective of the fact that it may be secured by improved real property.

(*f*) *Distributions to shareholders.*—Subsection (f) of section 593, as amended by the bill, prescribes rules governing certain distributions of property (as defined in sec. 317(a)) by a domestic building and loan association to a shareholder with respect to its stock, if such distribution is not allowable as a deduction under section 591. The term "distribution" is defined in paragraph (3)(C) to include any distribution in redemption of stock or in partial or complete liquidation of the association.

Paragraph (1) of subsection (f) provides that a distribution shall be treated as made, first out of the reserve for losses on qualifying real property loans to the extent that the additions made to such reserve pursuant to section 593, as amended by the bill, exceed the additions thereto which would have been allowed under section 166(c) of the code (without regard to sec. 593). The additions made to such reserve include amounts initially added to the reserve pursuant to the allocation rules of subsection (c). The distribution is then treated as made out of the supplemental reserve for losses on loans, to the extent thereof; then out of the association's earnings and profits accumulated in taxable years beginning after December 31, 1951, to the extent thereof; and finally, out of such other accounts as may be proper.

Paragraph (2) of subsection (f) provides that, if a distribution described in paragraph (1) is treated as having been made out of the reserve for losses on qualifying real property loans or out of the supplemental reserve for losses on loans, the amount charged against such reserve shall be the amount which, when reduced by the amount of Federal income tax attributable to the inclusion of such amount in gross income, is equal to the amount of such distribution. Any amount so charged against such reserve shall be included in the gross income of the distributor association. Since the amount so included in gross income is also included in earnings and profits, the effect of subsection (f) is to treat such amount as having been first transferred from the reserves to earnings and profits and then charged to earnings and profits. Thus this rule will normally insure that there will be earnings and profits sufficient to make distributions which are in reality dividends taxable as such, even though the association has previously deducted, in computing its earnings and profits, the amount of additions to its bad debt reserves. However, apart from the consequences which flow from the fact that earnings and profits will be created by such charges to the reserves, income tax consequences to stockholders are not otherwise affected by subsection (f).

Paragraph (3) of subsection (f) provides special rules. Subparagraph (A) provides that, for purposes of treating a distribution as having been made out of the reserve for losses on qualifying real property loans, additions to such reserve for the taxable year in which the distribution occurs shall be taken into account. Thus, the amount of such reserve will be augmented by the addition to such reserve computed under subsection (b) before the reserve is reduced by reason of treating a distribution as having been made out of the reserve. Subparagraph (B) provides that, for purposes of computing (under sec. 593, as amended by the bill) the amount of a reasonable addition to the reserve for losses on qualifying real property loans for any taxable year, any amount charged during any year to such reserve pursuant to the provisions of paragraph (2) of subsection (f)

shall not be taken into account. Thus, the amount by which such reserve is reduced by reason of distributions to stockholders cannot serve as the basis for subsequent deductible additions to such reserve.

SECTION 8. MUTUAL SAVINGS BANKS, ETC. (Continued)

(*b*) *Foreclosure on property securing loans.*—Subsection (b) of section 8 of the bill adds a new section 595 to the code. The section applies only to a creditor which is a mutual savings institution described in the amended section 593(a).

Nonrecognition of gain or loss as a result of foreclosure

Subsection (a) of the new section 595 provides that in the case of a creditor which is an organization described in section 593(a), no gain or loss shall be recognized, and no debt shall be considered as becoming worthless or partially worthless, as the result of such organization having bid in at foreclosure, or having otherwise reduced to ownership or possession by agreement or process of law, any property which was security for the payment of any indebtedness.

Character of property

Subsection (b) of the new section 595 provides that, for purposes of sections 166 (relating to the deduction for bad debts) and 1221 (relating to the definition of a capital asset), any property acquired in a transaction with respect to which gain or loss was not recognized to the creditor by reason of subsection (a) shall be considered as property having the same characteristics as the indebtedness for which such property was security. The subsection further provides that any amount realized by such creditor with respect to such property shall be treated (for purposes of ch. 1 of the code) as a payment on account of such indebtedness, and that any loss with respect to such property shall be treated as a bad debt to which the provisions of section 166 apply.

Basis

Subsection (c) of the new section 595 provides that the basis of any property acquired in a transaction to which subsection (a) applies shall be the basis of the indebtedness for which such property was security, determined as of the date of the acquisition of such property, properly increased for any costs of acquisition.

Regulatory authority

Subsection (d) of the new section 595 provides that the Secretary of the Treasury or his delegate shall prescribe such regulations as he may deem necessary to carry out the purposes of this section.

(*c*) *Definition of domestic building and loan association.*—Subsection (c) of section 8 of the bill amends paragraph (19) of section 7701(a) of the code to provide a new definition of the term "domestic building and loan association". As amended, paragraph (19) of section 7701(a) defines such term to mean any domestic building and loan association, domestic savings and loan association, or Federal savings and loan association, which is either (i) an insured institution within the meaning of section 401(a) of the National Housing Act (12 U.S.C., § 1724(a)), or (ii) is subject by law to supervision and examination by State or Federal authority having supervision over such associations, but only if substantially all of its business meets specified requirements.

The "insured institutions" referred to are those the accounts of which are insured by the Federal Savings and Loan Insurance Corporation. The new definition requires that substantially all the business of an association consist of accepting savings and investing the proceeds (i) in loans secured by real property which is (or, from the proceeds of the loan, will become) residential real property, and (ii) in other loans, to the extent such other loans would be authorized to be made by a Federal savings and loan association under the second paragraph of section 5(c) of the Home Owners' Loan Act, as amended (12 U.S.C., § 1464(c)). These provisions authorize a Federal savings and loan association to invest a sum not in excess of 15 percent of its assets in specified loans, including unsecured loans, for property alteration, repair, or improvement.

(*d*) *Clerical amendments.*—Subsection (d) of section 8 of the bill contains clerical amendments.

(*e*) *Repeal of exemption from communications and transportation of persons taxes.*—Under section 5(h) of the Home Owners' Loan Act of 1933 (48 Stat. 132; 12 U.S.C., § 1464(h)), Federal savings and loan associations are exempted from the excise tax on communications and the excise tax on the transportation of persons now imposed by sections 4251 and 4261 of the code. Subsection (e) of section 8 of the bill provides that, notwithstanding any other provision of law, a Federal savings and loan association shall not be exempt as such from the excise taxes imposed by sections 4251 and 4261 of the code.

(*f*) *Effective dates.*—Subsection (f) of section 8 of the bill provides effective dates for subsections (a), (b) and (e) of section 8 of the bill.

Paragraph (1) of section 8(f) of the bill provides that the amendments made by section 8(a) of the bill (which amends sec. 593 of existing law) shall apply to taxable years ending after December 31, 1962, except that section 593(f) of the code shall apply to distributions after December 31, 1962, in taxable years ending after such date.

Paragraph (2) of section 8(f) of the bill provides that the amendments made by section 8(b) of the bill (which adds a new sec. 595) shall apply to transactions described in section 595(a) of the code occurring after December 31, 1962, in taxable years ending after such date.

Paragraph (3) of section 8(f) of the bill provides that subsection (e) shall apply, in the case of the tax imposed by section 4251 of the code, with respect to amounts paid pursuant to bills rendered after June 30, 1962; and, in the case of the tax imposed by section 4261 of the code, with respect to transportation beginning after June 30, 1962.

SECTION 9. DISTRIBUTIONS BY FOREIGN TRUSTS

(*a*) *Definitions.*—Section 9(a) of the bill amends section 643 of the 1954 Code (definitions relating to the income of estates and trusts) in the following respects.

Modification of distributable net income

Section 9(a)(1) of the bill amends section 643(a)(6) (relating to modifications taken into account in computing distributable net income) in two respects. First, a new subparagraph (B) is added to section 643(a)(6) to provide that the gross income of a foreign

trust from sources within the United States is to be determined without regard to section 894 (relating to income exempt under treaty). A further amendment is made to section 643(a)(6) by the addition of a new subparagraph (C). The new section 643(a)(6)(C) provides that section 643(a)(3) (relating to capital gains and losses) is not to apply to a "foreign trust created by a United States person", as defined in section 643(d). In lieu of the rules provided by section 643(a)(3), the new subparagraph (C) provides that there is to be included in distributable net income gains from the sale or exchange of capital assets, reduced by losses from such sales or exchanges to the extent such losses do not exceed gains from such sales or exchanges. The new subparagraph (C) also provides that the deduction under section 1202 (relating to deduction for excess of capital gains over capital losses) is not to be taken into account. Existing section 643(a)(3) will continue to apply to trusts other than foreign trusts created by United States persons.

Foreign trusts created by United States persons

Section 9(a)(2) of the bill adds a new subsection (d) to section 643 of the 1954 Code. The new section 643(d) provides that, for purposes of part I of subchapter J (relating to estates, trusts, and beneficiaries), the term "foreign trust created by a United States person" means a foreign trust (as defined in sec. 7701(a)(31)) to which money or property has been transferred directly or indirectly by a United States person (as defined in sec. 7701(a)(30)), or under the will of a decedent who at the date of his death was a United States citizen or resident. A foreign trust, created by a person who is not a United States person, to which a United States person transfers money or property would under this definition be a foreign trust created by a United States person.

(*b*) *Modification of throwback.*—Subsections (b) through (d) of section 9 of the bill make various amendments designed to modify the so-called throwback provisions of the code in their application to certain foreign trusts.

Existing law

Under existing law the so-called throwback provisions of subchapter J operate substantially as follows. When a beneficiary receives as a distribution an amount in excess of current distributable net income, and the distribution exceeds $2,000, it is called an accumulation distribution. The beneficiary is taxed on this amount to the extent there was undistributed net income of the trust in any of the preceding 5 years, the undistributed net income of such prior years being taken into account in inverse order. Undistributed net income consists of undistributed distributable net income for a taxable year, minus the taxes on the trust attributable to such undistributed amount. The beneficiary is also required to include in gross income an appropriate portion of the United States income taxes, if any, imposed on the trust with respect to the undistributed net income, but he receives a tax credit based on the taxes the trust would not have had to pay if the undistributed distributable net income had actually been paid to the beneficiary.

Although under section 668(a) the beneficiary is taxable currently on the entire distribution, as well as on the taxes on the trust allocable

to that amount, the tax attributable to the distribution cannot exceed the tax he would have paid had the distribution been paid to him on the last day of each of the preceding taxable years to the extent the undistributed net income of each of those years is considered absorbed by the distribution. The taxes deemed distributed to him are similarly spread back.

Under existing law, however, as noted, the throwback rule does not operate with respect to distributions made out of accumulations for taxable years before the fifth year preceding the taxable year. In addition, there are certain exceptions to what may be taken into account in determining whether there has been an accumulation distribution, e.g., a distribution out of accumulations for a minor, or a final distribution of the trust made to a beneficiary more than 9 years after the date of the last transfer to the trust.

Modification of accumulation distribution

Section 9(b)(1) of the bill amends section 665(b) (relating to the definition of accumulation distribution) to limit the application of such definition to trusts other than foreign trusts created by United States persons. A new section 665(c), added by section 9(b)(2) of the bill, provides a definition of accumulation distribution for foreign trusts created by United States persons. Under this new definition, a distribution in excess of current distributable net income constitutes an accumulation distribution whether or not the distribution exceeds $2,000. In addition, there are no exceptions to what may be taken into account in determining whether there has been an accumulation distribution. Thus, any distribution in excess of current distributable net income will, under the new section 665(c), be an accumulation distribution.

The last sentence of section 665(c) provides that any amount paid to a United States person which is from a payor who is not a United States person, and which is derived directly or indirectly from a foreign trust created by a United States person, is to be deemed in the year of payment to have been directly paid by the foreign trust. Thus, if a nonresident alien receives a distribution from a foreign trust created by a United States person and he then pays the amount of the distribution over to a United States person, the payment of such amount to the United States person represents an accumulation distribution to the United States person from such trust, to the extent that the amount received would have been an accumulation distribution had the trust paid the amount directly to the United States person. An example of a payment indirectly derived by a nonresident alien from such a foreign trust would be where the trust distributes to a foreign trust which was not created by a United States person, and which latter foreign trust makes a distribution to the nonresident alien. In this case, the payment over to a United States person is considered to have been made from the initial and not from the intervening trust. The same result would obtain if the intervening trust were a foreign trust created by a United States person. However, even if a payment is made to a United States person by a person who is not a United States person and who directly or indirectly derived the amount paid from a foreign trust created by a United States person, the receipt of the amount by the United States person is not considered the receipt of an accumulation distribution from a trust if the

amount is received under circumstances indicating lack of intent on the part of the parties to circumvent the amendments made by section 9 of the bill.

Other modifications to the throwback rule

The restriction of the throwback rule to the 5 preceding taxable years of the trust is removed by section 9(c)(2) of the bill for foreign trusts created by a United States person. However, this unlimited throwback will operate only for years governed by the 1954 Code.

Section 9(d) of the bill adds a new sentence to section 668(a) (relating to amounts treated as received in prior taxable years). In the case of a United States person who is a beneficiary of a foreign trust created by a United States person, this sentence conditions the availability of the limitation on tax provided by section 668(a) on a beneficiary's meeting the information requirements of new section 669(b), added by section 9(e) of the bill.

The provisions of subchapter J which remain unchanged by the bill will continue to apply as under existing law. Thus, the credit allowed to a beneficiary by section 668(b) for United States income taxes paid by the trust, and the credit against tax for taxes imposed by foreign countries will continue to be available.

SECTION 9. DISTRIBUTIONS BY FOREIGN TRUSTS (Continued)

(*e*) *Limitation on tax.*—Section 9(e) of the bill adds a new section 669 to subpart D of part 1 of subchapter J of chapter 1 (relating to treatment of excess distributions by trusts).

SECTION 669. SPECIAL RULES APPLICABLE TO CERTAIN FOREIGN TRUSTS

Section 669 provides that a beneficiary who is a United States person and who satisfies certain additional requirements may elect between two methods of computing the limitation on tax attributable to an accumulation distribution received from a foreign trust created by a United States person. These two methods are in addition to the method available to the beneficiary of computing his tax in the ordinary way by including in income the entire amount of an accumulation distribution when it is paid, credited, or required to be distributed. The additional requirements referred to which must be satisfied by the beneficiary are those provided in section 669(b), relating to the furnishing of certain information by the beneficiary with respect to the operation and accounts of the trust. Information may be required to be furnished for each taxable year of the trust on the last day of which an amount is deemed distributed by the trust under section 666(a). The nature and extent of the information required is to be determined by regulations prescribed by the Secretary of the Treasury or his delegate.

First method of limiting tax

As noted above, section 669(a) provides for an election by the beneficiary as between two methods of computing the limitation on tax attributable to the receipt of an accumulation distribution. The first method is the one provided by existing law, and which is now

contained in the next to the last sentence of section 668(a). However, section 669(a)(2)(B) provides that this method may not be elected if the beneficiary was not alive on the last day of each preceding taxable year of the trust with respect to which a distribution is deemed made under section 666(a). Thus, if a portion of an amount received as an accumulation distribution was accumulated by the trust during years when the beneficiary was unborn, the beneficiary is not permitted to elect the limitation on tax provided by section 669(a)(1)(A).

Second method of limiting tax

The second method of limiting tax is provided by section 669(a)(1)(B). Under this method the beneficiary's gross income for the taxable year in which the accumulation distribution is paid, credited, or required to be distributed to him (determined without regard to the inclusion in income required by sec. 668(a) of any amount other than pursuant to sec. 669(a)(1)(B)) and for each of his 2 taxable years immediately preceding such year is recomputed solely for purposes of determining the limitation on the beneficiary's tax for the current year. The income for each of such 3 years is recomputed by adding thereto an amount determined by dividing the amount required to be included in income under section 668(a) by the number of preceding taxable years of the trust on the last day of each of which an amount is deemed under section 666(a) to have been distributed. There is then computed the increase in tax for each of such 3 years attributable to the increased amount of gross income. The aggregate of the increases in tax for such 3 years is divided by 3 to arrive at an average increase in tax for such 3 years. This average increase in tax, multiplied by the number of preceding taxable years of the trust from the income of which the distribution is made, is the limitation on the beneficiary's tax liability (before the application of any credit for taxes paid by the trust allowed by sec. 668(b)) with respect to the accumulation distribution.

The computation made under the alternate election provided by section 669(a)(1)(B) is modified in two cases. When an accumulation distribution is deemed under section 666(a) to have been distributed on the last day of less than 3 taxable years of the trust, the taxable years of the beneficiary for which a recomputation is made under section 669(a)(1)(B) is limited to the number of years to which section 666(a) applies, commencing with the most recent taxable year of the beneficiary. Also, no recomputation of gross income is to be made for a beneficiary for a taxable year for which he was not alive on the last day thereof; and if the beneficiary has no preceding taxable year, the recomputation of gross income is made on the basis of his taxable year without regard to the inclusion in income required by section 668(a) of any amount other than pursuant to section 669(a)(1)(B).

The application of the preceding paragraph may be illustrated by the following examples: Assume that a foreign trust created by a United States person accumulates $3,000 of income for one year and $7,000 for a second year and then distributes the accumulated income on January 1, 1965, to a beneficiary who is a United States person. The limitation on tax computed under section 669(a)(1)(B) would be determined by recomputing the beneficiary's gross income for

1964 and 1965 by adding $5,000 to each year. If the same distribution were made to an infant who was born in 1965, the limitation on tax would be computed by adding $5,000 to his gross income for such year. The resulting increase in tax would be multiplied by two to arrive at the limitation on the increase in his tax for 1965 attributable to such distribution.

Effect of prior election

Section 669(a)(3) provides special rules which have application when a beneficiary who is a United States person receives a second or succeeding accumulation distribution from a foreign trust created by a United States person.

If a beneficiary has elected the limitation on tax provided by section 669(a)(1)(B) (the second method described herein) with respect to an accumulation distribution, and with respect to a subsequent accumulation distribution he desires to elect the limitation on tax provided by section 669(a)(1)(A) (the method provided by existing law), for purposes of computing the limitation on tax with respect to the subsequent accumulation distribution the income of any year with respect to which an amount is deemed distributed to a beneficiary under section 666(a) is to include amounts previously deemed distributed to such beneficiary for such year as a result of an accumulation distribution with respect to which an election under section 669(a)(1)(B) was made. The result of this rule is to require that for the purposes of computing the limitation on tax under section 669(a)(1)(A) with respect to an accumulation distribution, all previous elections are considered to have been made under section 669(a)(1)(A). However, this rule does not deny to the beneficiary the benefit previously derived by him as a result of an election under section 669(a)(1)(B) with respect to an earlier accumulation distribution.

A special rule is also provided by section 669(a)(3) regardless of the limitation on tax elected with respect to a prior accumulation distribution when, with respect to a subsequent accumulation distribution, the limitation on tax provided by section 669(a)(1)(B) is elected by the beneficiary. When this occurs the number of preceding taxable years of the trust with respect to which an amount is deemed distributed to a beneficiary under section 666(a) is to be determined without regard to any such year with respect to which an amount was previously deemed distributed to such beneficiary.

SECTION 9. DISTRIBUTIONS BY FOREIGN TRUSTS (Continued)

(*f*) *Requirement of information return.*—Section 9(f) of the bill amends subpart B of part III of subchapter A of chapter 61 (relating to information concerning transactions with other persons) by adding a new section 6047.

SECTION 6047. RETURNS AS TO CREATION OF OR TRANSFERS TO CERTAIN FOREIGN TRUSTS

Section 6047 provides for the filing of an information return on or before the 90th day after the creation of any foreign trust by a United States person or after the transfer of any money or property to a

foreign trust by a United States person. The return is to be in such form and is to set forth, in respect of the foreign trust, such information as the Secretary of the Treasury or his delegate prescribes by regulation as necessary for carrying out the provisions of the income tax laws. The return is required to be filed by the grantor in the case of an inter vivos trust, the fiduciary of an estate in the case of a testamentary trust, or by the transferor to a foreign trust, as the case may be.

(*g*) *Penalty for failure to file return.*—Section 9(g) of the bill amends subchapter B of chapter 68 (relating to assessable penalties) by adding a new section 6677.

SECTION 6677. FAILURE TO FILE INFORMATION RETURNS WITH RESPECT TO CERTAIN FOREIGN TRUSTS

Section 6677(a) provides that, in addition to any criminal penalty provided by law (such as the penalty provided by sec. 7203 for willful failure to file a return), any person required to file a return under section 6047 who fails to file such return at the time provided in such section, or who files a return which does not show the information required pursuant to such section, is to pay a penalty equal to 5 percent of the amount transferred to a trust, but not more than $1,000, unless it is shown that such failure is due to reasonable cause.

Section 6677(b) provides that the assessment or collection of any penalty imposed by section 6677(a) is not to be subject to the deficiency procedures provided by subchapter B of chapter 63 of the code.

(*h*) *Definitions.*—Section 9(h) of the bill amends section 7701(a) (relating to definitions) by adding paragraphs (30) and (31). Paragraph (30) defines the term "United States person" to mean a citizen or resident of the United States; a domestic partnership; a domestic corporation; and any estate or trust (other than a foreign estate or foreign trust, within the meaning of sec. 7701(a)(31)). Paragraph (31) defines the terms "foreign estate" and "foreign trust" to mean an estate or trust, as the case may be, the income of which from sources without the United States is not includible in gross income under subtitle A of the code (relating to income taxes).

(*i*) *Technical amendments.*—Section 9(i) of the bill amends the tables of sections where necessary to reflect the addition of the new sections added by the bill.

(*j*) *Effective date.*—The amendments made by section 9 of the bill (other than by subsecs. (f), (g), and (h)) are to apply with respect to distributions made in taxable years of trusts beginning after the date of the enactment of the bill. The amendments made by subsections (f), (g), and (h) will take effect on such date of enactment.

SECTION 10. MUTUAL INSURANCE COMPANIES (OTHER THAN LIFE, MARINE, AND CERTAIN FIRE INSURANCE COMPANIES), ETC.

(*a*) *Imposition of tax.*—Subsection (a) of section 10 of the bill amends the heading and table of sections for part II of subchapter L of chapter 1 of the 1954 Code to conform them to the substantive changes made by the bill. In addition, subsection (a) in effect strikes

out existing section 821 of the code and substitutes a new section 821, relating to the tax on mutual insurance companies to which part II applies.

SECTION 821. TAX ON MUTUAL INSURANCE COMPANIES TO WHICH PART II APPLIES

(*a*) *Imposition of tax.*—Subsection (a) of the new section 821 provides the general rule for taxing mutual insurance companies (including interinsurers and reciprocal underwriters). The tax will not apply to a mutual life insurance company or to a mutual marine or mutual fire insurance company subject to the tax imposed by section 831 of the 1954 Code. In addition, the tax will not apply if the alternative tax imposed by the new section 821(c) (relating to alternative tax for certain small companies) applies. Also, mutual insurance companies (other than life or marine) whose gross receipts (not including capital gains) for the taxable year do not exceed $75,000 will continue to be exempt from tax under section 501(c)(15) of the 1954 Code.

The tax imposed by the new section 821(a) applies to each taxable year beginning after December 31, 1962. The tax is to consist of—

(1) a normal tax of 25 percent of the mutual insurance company taxable income, or 50 percent of the amount by which such taxable income exceeds $6,000, whichever is the lesser; and

(2) a surtax of 22 percent of the mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) in excess of $25,000.

Under existing law a mutual insurance company which is subject to the tax on investment income only is exempt from tax if its mutual insurance company taxable income does not exceed $3,000. Similarly, existing law provides special notch relief if such a company has mutual insurance company taxable income between $3,000 and $6,000. Under the bill, companies having mutual insurance company taxable income (as defined in the new sec. 821(b)) which does not exceed $6,000 will be exempt from tax, and the special notch provision will apply if the company has mutual insurance company taxable income between $6,000 and $12,000.

(*b*) *Mutual insurance company taxable income defined.*—Subsection (b) of the new section 821 defines the term "mutual insurance company taxable income" for purposes of part II of subchapter L. Under this definition, mutual insurance company taxable income means the amount by which—

(1) the sum of—

(A) the taxable investment income (as defined in sec. 822(a)(1)),

(B) the statutory underwriting income (as defined in sec. 823(a)(1)), and

(C) the amounts required by section 824(d) to be subtracted from the protection against loss account, exceeds

(2) the sum of—

(A) the investment loss (as defined in sec. 822(a)(2)), if any,

(B) the statutory underwriting loss (as defined in sec. 823(a)(2)), if any, and

(C) the unused loss deduction provided by section 825(a).

If for any taxable year the amount determined under paragraph (2) of the new section 821(b) exceeds the amount determined under paragraph (1) of the new section 821(b), the mutual insurance company taxable income shall be zero.

(c) *Alternative tax for certain small companies.*—Paragraph (1) of the new section 821(c) provides an alternative tax which is in lieu of the tax imposed by section 821(a) for taxable years beginning after December 31, 1962. Except as provided in section 821(c)(3)(B), this tax applies in the case of every mutual insurance company described in section 821(c)(3)(A) and consists of—

> (1) a normal tax of 25 percent of the taxable investment income (as defined in sec. 822(a)(1)), or 50 percent of the amount by which such taxable income exceeds $3,000, whichever is the lesser; and
>
> (2) a surtax of 22 percent of the taxable investment income (computed without regard to the deduction provided in sec. 242 for partially tax-exempt interest) in excess of $25,000.

Thus, paragraph (1) of the new section 821(c) provides, in effect that certain small mutual insurance companies shall be taxed at regular corporate rates on taxable investment income only. Under the bill, such companies will continue to be taxed the same as under present law, except that the alternative 1-percent tax will not apply. Accordingly, if such a company has taxable investment income of less than $3,000, it is not subject to tax, and if the taxable investment income is between $3,000 and $6,000, it is entitled to special notch relief. Unless such a company makes an election to be taxed under section 821(a), its underwriting gains or losses will not be taken into account for purposes of determining its tax liability.

Paragraph (2) of the new section 821(c) is identical to section 821(c) of existing law which provides a special tax reduction for companies subject to tax under section 821. Under present law, if the gross amount received during the taxable year from the items described in section 822(b) (other than par. (1)(D) thereof) and premiums (including deposits and assessments) is over $75,000 but less than $125,000, the tax otherwise computed under existing section 821(a) (1) or (2) or section 821(b) is reduced to an amount which bears the same proportion to such tax as the excess over $75,000 bears to $50,000. However, under the bill, this special relief provision is to apply only to companies which are subject to the tax imposed by the new section 821(c) and is not to apply in the case of companies which are subject to the tax imposed by the new section 821(a).

Subparagraph (A) of the new section 821(c)(3) provides that, except as provided by section 821(c)(3)(B), every mutual insurance company (other than a life insurance company and other than a fire or marine insurance company subject to the tax imposed by sec. 831) is to be subject to the tax imposed by section 821(c) if the gross amount received during the taxable year from the items described in section 822(b) (other than par. (1)(D) thereof) and premiums (including deposits and assessments) exceeds $75,000 but does not exceed $300,000.

Subparagraph (B) of the new section 821(c)(3) provides that a mutual insurance company described in section 821(c)(3)(A) shall not

be subject to the alternative tax imposed by section 821(c)(1) for the taxable year if there is in effect for the taxable year an election made by such company under section 821(d) to be taxable under section 821(a), or if there is any amount in the protection against loss account of such company at the beginning of the taxable year. Where the alternative tax treatment for certain small companies does not apply by reason of there being an amount in the protection against loss account at the beginning of the taxable year, the bill provides that an election may be made to subtract such amount from the protection against loss account as of the close of the preceding taxable year. See section 824(d)(5).

(*d*) *Election to include statutory underwriting income or loss.*—Paragraph (1) of the new section 821(d) provides that any mutual insurance company which is subject to the tax imposed by section 821(c) may elect to be subject to the tax imposed by section 821(a). Paragraph (2) provides that if the company makes such an election it shall be subject to the tax imposed by section 821(a) for the first taxable year for which the election is made and for all taxable years thereafter unless the Secretary or his delegate consents to a revocation of such election. Under the bill, it is not intended to permit such companies an annual election to be taxed either under subsection (a) or (c) of the new section 821. However, there may be some situations where because of a substantial change in the character of the taxpayer's operations there would be an undue burden or material hardship if such taxpayer were not permitted to revoke its prior election. Under such circumstances, the bill provides that the election may be revoked with the consent of the Secretary or his delegate. If, however, for any taxable year for which the election would otherwise apply, the gross amount received by the company during the taxable year from the items described in section 822(b) (other than par. (1)(D) thereof) and premiums (including deposits and assessments) does not exceed $75,000, such election will terminate automatically. Thus, if for any taxable year thereafter such a company has gross receipts from such sources of over $75,000 but not more than $300,000, it shall be subject to tax under section 821(c) unless it makes a new election to be taxed under section 821(a).

(*e*) *No United States insurance business.*—Subsection (e) of the new section 821 is identical with section 821(d) of existing law and provides that foreign mutual insurance companies (other than a life insurance company and other than a fire or marine insurance company subject to the tax imposed by sec. 831) not carrying on an insurance business within the United States are not to be subject to tax under part II of subchapter L but shall be taxable as other foreign corporations. See section 881 of the code.

(*f*) *Cross references.*—Subsection (f) of the new section 821 contains cross references to section 501(c)(15) of the code (relating to exemption from tax of certain mutual insurance companies) and section 1201(a) (relating to alternative tax in case of capital gains).

SECTION 10. MUTUAL INSURANCE COMPANIES (OTHER THAN LIFE, MARINE, AND CERTAIN FIRE INSURANCE COMPANIES), ETC.—(Continued)

(*b*) *Taxable investment income.*—Subsection (b) of section 10 of the bill contains technical amendments to sections 822 and 823 of the code. These amendments, in effect, retain the existing substantive provisions of section 822 but change the designation of the excess of gross investment income (as defined in sec. 822(b)) over gross investment deductions (as provided in sec. 822(c)) from "mutual insurance company taxable income" to "taxable investment income."

Subsection (b)(1) of section 10 of the bill changes the heading of section 822 to refer to taxable investment income and amends section 822(a) to define the terms "taxable investment income" and "investment loss" for purposes of part II of subchapter L. The investment loss is the excess of gross investment deductions over gross investment income.

Subsection (b)(2) of section 10 of the bill amends section 822(c) of the code (relating to deductions) and section 822(e) of the code (relating to foreign mutual insurance companies) by striking out the term "mutual insurance company taxable income" each place it appears and inserting in lieu thereof the term "taxable investment income". This amendment conforms to the amendment to section 822(a).

Subsection (b)(3) of section 10 of the bill amends section 822(c)(7) of the code (relating to special deductions) and provides that for purposes of paragraph (7) of section 822(c), in applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received), the reference in section 246(b) to "taxable income" is to be treated as a reference to "taxable investment income."

Subsection (b)(4) of section 10 of the bill redesignates section 823 of the code (relating to other definitions) as subsection (f) of the new section 822.

(*c*) *Statutory underwriting income or loss.*—Subsection (c) of section 10 of the bill adds (after sec. 822(f), as redesignated by subsec. (b)(4) of sec. 10 of the bill) a new section 823, relating to determination of statutory underwriting income or loss, and a new section 824, relating to adjustments to provide protection against losses.

SECTION 823. DETERMINATION OF STATUTORY UNDERWRITING INCOME OR LOSS

(*a*) *In general.*—Paragraph (1) of the new section 823(a) defines the term "statutory underwriting income" for purposes of part II of subchapter L. Under this definition, statutory underwriting income is the amount by which—

(1) the gross income which would be taken into account in computing taxable income under section 832 if the taxpayer were subject to the tax imposed by section 831, reduced by the gross investment income (as determined under sec. 822(b)), exceeds

(2) the sum of—

(A) the deductions which would be taken into account in computing taxable income if the taxpayer were subject to

the tax imposed by section 831, reduced by the deductions provided in section 822(c) (relating to deductions in computing taxable investment income), plus

(B) the deductions provided in subsection (c) of the new section 823 (relating to special deduction for small company having gross amount of less than $900,000) and in section 824(a) (relating to deduction to provide protection against losses).

Paragraph (2) of the new section 823(a) provides that, for purposes of part II of subchapter L, the term "statutory underwriting loss" means the amount by which the amount referred to in paragraph (1)(B) of the new section 823(a) exceeds the amount referred to in paragraph (1)(A) of the new section 823(a).

Paragraphs (1) and (2) of the new section 823(a) provide, in effect, that for purposes of determining statutory underwriting income or loss for the taxable year a mutual insurance company subject to the tax imposed by section 821(a) must first take into account the same gross income and deduction items (except as modified by sec. 823(b)) as a taxpayer subject to tax under section 831 would take into account for purposes of determining its taxable income under section 832. These items are then reduced to the extent that they include amounts which are included in determining taxable investment income under section 822(a). In addition, the taxpayer is allowed a deduction for the amount determined under section 824(a) (relating to deduction to provide protection against losses) and, in the case of a company having gross receipts of less than $900,000, an additional deduction equal to the amount determined under section 823(c)(1), after the application of the limitation provided in section 823(c)(2).

(*b*) *Modifications.*—Subsection (b) of the new section 823 provides certain modifications to the general rule for determining statutory underwriting income or loss contained in section 823(a). Paragraph (1) of section 823(b) provides that for purposes of applying section 823(a), the deduction for net operating losses provided by section 172 is not to be allowed. (However, such a company is allowed an unused loss deduction under the provisions of sec. 825.) Paragraph (2) of the new section 823(b) provides a special rule which applies in the case of an interinsurer or reciprocal underwriter which is subject to the tax imposed by section 821(a). This rule provides that if such a company, before the 16th day of the 3d month following the close of the taxable year, credits the individual account of each of its subscribers with an amount, representing savings to subscribers for the taxable year, which it would be obligated to pay promptly to such subscriber if he terminated his contract at the close of the company's taxable year, then—

(1) there is to be allowed as a deduction the increase for the taxable year in savings credited to subscriber accounts, or

(2) there is to be included as an item of gross income the decrease for the taxable year in savings credited to subscriber accounts.

Any amount representing savings credited to his account for the taxable year is to be treated by the subscriber as a dividend paid or declared for purposes of his taxable income. Thus, the amount of any savings credited to a subscriber within the meaning of this section shall be taken into account by him in computing his income to the

extent that the cost of the insurance with respect to which the savings are credited constitutes a business expense.

(c) *Special deduction for small company having gross amount of less than $900,000.*—Subsection (c) of the new section 823 relates to the special deduction for certain small companies having gross receipts of less than $900,000. Paragraph (1) of the new section 823(c) provides that if the gross amount received during the taxable year from the items described in section 822(b) (other than par. (1)(D) thereof) and net premiums (including deposits and assessments) is less than $900,000, then, subject to the limitation provided in paragraph (2) of the new section 823(c) there shall be allowed an additional deduction for purposes of determining statutory underwriting income or loss (under subsec. (a) of the new sec. 823) for the taxable year. This additional deduction is $6,000; except that if the gross amount exceeds $300,000, the additional deduction is limited to an amount equal to 1 percent of the amount by which $900,000 exceeds such gross amount. The special deduction provided by paragraph (1) does not apply if the taxpayer is either subject to the tax imposed by section 821(c) (relating to alternative tax for certain small companies) or has gross amounts of $900,000 or more.

Paragraph (2) of the new section 823(c) provides that the amount of the deduction allowed under paragraph (1) of the new section 823(c) is not to exceed the statutory underwriting income (as defined in sec. 823(a)(1)) for the taxable year, computed without regard to the deduction under paragraph (1) or the deduction allowed under section 824(a) (relating to deduction for protection against losses).

Example: The application of section 823(c) may be illustrated by the following example:

Company M, a mutual insurance company subject to the tax imposed by section 821(a), has the following items for the taxable year 1963:

Gross amount for purposes of sec. 823(c)(1)	$400, 000
Gross investment income (including capital gains)	75, 000
Capital gains	50, 000
Gross income under sec. 832	450, 000
Deductions under sec. 822(c)	71, 000
Deductions under sec. 832 (as modified by sec. 823(b))	433, 000

Under the provisions of section 823(c), company M's special small company deduction for the taxable year 1963 would be $5,000, computed as follows:

(1) Gross amount for purposes of sec. 823(c)(1)		$400, 000
(2) Amount by which $900,000 exceeds item (1) ($900,000 minus $400,000)		500, 000
(3) 1 percent of item (2), not to exceed $6, 000		5, 000
(4) Gross income under sec. 832, reduced by gross investment income ($450,000 minus $75,000)	$375, 000	
(5) Deductions under sec. 832 (as modified by sec. 823(b), reduced by deductions under sec. 822(c) ($433,000 minus $71,000)	362, 000	
(6) Limitation on deduction under sec. 823(c)(1) (excess, if any, of item (4) over item (5))		13, 000
(7) Deduction under sec. 823(c)(1) (item (3) or item (6), whichever is the lesser)		5, 000

SECTION 824. ADJUSTMENTS TO PROVIDE PROTECTION AGAINST LOSSES

(*a*) *Allowance of deduction.*—Paragraph (1) of the new section 824(a) provides that for purposes of determining the statutory underwriting income or loss (as defined in sec. 823(a)) for any taxable year there is to be allowed as a deduction to provide protection against losses the sum of—

(1) 1 percent of the losses incurred during the taxable year (as determined under sec. 832(b)(5)); plus

(2) 25 percent of the underwriting gain for the taxable year; plus

(3) if the concentrated windstorm, etc., premium percentage for the taxable year (as defined in par. (2) of the new sec. 824(a)) exceeds 50 percent, the amount determined by applying so much of the concentrated windstorm, etc., premium percentage as exceeds 50 percent to the underwriting gain for the taxable year.

For purposes of paragraph (1) of the new section 824(a), the term "underwriting gain" means the statutory underwriting income computed under section 823(a) without regard to the deduction provided by paragraph (1) of the new section 824(a).

Subparagraph (C) of the new section 824(a)(1) permits an additional deduction for protection against losses in the case of certain companies having concentrated windstorm, etc., risks. For example, assume that for the taxable year 1963, W, a mutual insurance company subject to the tax imposed by section 821(a), has an underwriting gain (for purposes of sec. 824(a)) of $100. Assume further that W's concentrated windstorm, etc., premium percentage (as determined under sec. 824(a)(2)) for the taxable year is 70 percent, and losses incurred during the taxable year are $1,000. Under the provisions of section 824(a), W's deduction for protection against losses for 1963 would be $55. Of this amount, $10 (1 percent of losses incurred, or 1 percent of $1,000) is due to the application of section 824(a)(1)(A), $25 (25 percent of underwriting gain, or 25 percent of $100) is due to the application of section 824(a)(1)(B), and $20—the amount determined by multiplying the underwriting gain by so much of the concentrated windstorm, etc., premium percentage as exceeds 50 percent, or 20 percent (70 percent minus 50 percent) times $100—is due to the application of section 824(a)(1)(C).

Paragraph (2) of the new section 824(a) defines the term "concentrated windstorm, etc., premium percentage" for any taxable year as the percentage obtained by dividing—

(1) the amount of the premiums earned on insurance contracts during the taxable year (as defined in sec. 832(b)(4)), to the extent attributable to insurance against losses arising in any one State from windstorm, hail, flood, earthquake, or similar hazards, by

(2) the total amount of the premiums earned on insurance contracts during the taxable year (as defined in sec. 832(b)(4)).

For purposes of the preceding sentence the term "similar hazards" includes tornadoes, cyclones, and similar risks against natural phenomena but does not include insurance against fires, explosions, or riots. In the case of a company which issues contracts insuring against a combination of risks, some of which are included under this paragraph and some of which are not included under this paragraph,

a reasonable allocation of the premiums earned for the taxable year with respect to such contracts will be made for purposes of determining such company's concentrated windstorm, etc., premium percentage for the taxable year.

(*b*) *Protection against loss account.*—Subsection (b) of the new section 824 requires every insurance company subject to the tax imposed by section 821(a) for any taxable year to establish and maintain a protection against loss account. This account is to be established for taxable years beginning after December 31, 1962, and the beginning or opening balance of such account is to be zero.

(*c*) *Additions to account.*—Subsection (c) of the new section 824 relates to the amount which is to be added to the protection against loss account for each taxable year for which the taxpayer is subject to the tax under section 821(a). Subsection (c) of the new section 824 provides that the amount to be added to the protection against loss account is to be an amount equal to the deduction for protection against losses provided by section 824(a)(1).

(*d*) *Subtractions.*—Paragraphs (1), (4), and (5) of the new section 824(d) set forth the amounts which are to be subtracted from the protection against loss account. The amount which is required to be subtracted under section 824(d) is taken into account under section 821(b)(1)(C) for purposes of determining mutual insurance company taxable income.

Paragraph (1) of the new section 824(d) provides that, after making the additions required by section 824(c) for the taxable year, there shall be subtracted from the protection against loss account—

(A) first, an amount equal to the excess of the statutory underwriting loss for the taxable year over the underwriting loss (as defined in par. (6)) for the taxable year,

(B) then, the amount (if any) by which—

(i) the sum of the investment loss and the underwriting loss for such taxable year exceeds

(ii) the sum of the statutory underwriting income and the taxable investment income for such taxable year,

(C) next (in the order in which the losses occurred), amounts equal to the unused loss carryovers to such taxable year,

(D) next, any amount remaining which was added to the account for the fifth preceding taxable year, minus one-half of the underwriting gain remaining in the account for such taxable year which was added under subsection (a)(1)(B), and

(E) finally, the amount by which the total amount in the account exceeds whichever of the following is the greater:

(i) 10 percent of premiums earned on insurance contracts during the taxable year (as defined in sec. 832(b)(4)) less dividends to policyholders (as defined in sec. 832(c)(11)), or

(ii) the total amount in the account at the close of the preceding taxable year.

Under subparagraph (A) of the new section 824(d)(1), the first subtraction from the protection against loss account is made for so much of the statutory underwriting loss as is generated either by the deduction for dividends to policyholders (as defined in sec. 832(c)(11)) or by the deduction provided in section 824(a) for protection against losses. For purposes of subparagraph (A) of the new section 824(d)(1), an underwriting loss is not taken into account. The term

"underwriting loss" means a loss which is attributable to the payment of insurance claims and expenses and does not include losses which are attributable to the payment of dividends to policyholders or to the deduction to provide protection against losses.

Under subparagraph (B) of the new section 824(d)(1), the underwriting loss is subtracted from the protection against loss account but only to the extent that such loss exceeds the taxable investment income (as defined in sec. 822(a)(1)) for the taxable year. Subparagraph (B) of the new section 824(d)(1) further provides for a subtraction from the protection against loss account if the investment loss (as defined in sec. 822(a)(2)) for the taxable year, exceeds the statutory underwriting income (as defined in sec. 823(a)(1)) for the taxable year. The effect of this provision is to provide that no portion of an investment loss for any taxable year may be applied against mutual insurance company taxable income for any prior or subsequent taxable year unless the investment loss exceeds the balance in the protection against loss account at the close of the taxable year.

Subparagraph (D) of the new section 824(d)(1) provides for the subtraction of certain amounts added to the protection against loss account for any taxable year under section 824(c) if such amounts remain in the account for the next 5 taxable years. Under subparagraph (D) of the new section 824(d), the entire amount remaining in the account from the fifth preceding taxable year which was added by reason of section 824(a)(1)(A) (relating to deduction for 1 percent of losses incurred during the taxable year) or section 824(a)(1)(C) (relating to additional deduction for certain companies having concentrated windstorm, etc., risks) is to be subtracted from the protection against loss account. There is also to be subtracted under subparagraph (D) of the new section 824(d)(1) an amount representing one-half of the amount remaining in the account with respect to such fifth preceding taxable year which was added by reason of section 824(a)(1)(B) (relating to deduction for 25 percent of underwriting gain for the taxable year).

Subparagraph (E) of the new section 824(d)(1) provides (taking into account the priority rule in sec. 824(d)(3)(B)), in effect, a ceiling on the amount which can be added to and remain in the protection against loss account for the taxable year for which the amount is added. Subparagraph (E) provides that if the total amount in the account (as determined under sec. 824(d)(2)) exceeds the greater of (1) 10 percent of premiums earned on insurance contracts during the taxable year (as defined in sec. 832(b)(4)) less dividends to policyholders (as defined in sec. 832(c)(11)), or (2) the total amount in the account at the close of the preceding taxable year, then the amount of such excess shall be subtracted from the protection against loss account.

Paragraph (2) of the new section 824(d) contains rules for determining the ceiling on the protection against loss account. Paragraph (2) of the new section 824(d) provides that for purposes of paragraph (1)(E) of the new section 824(d), the total amount in the account is to be determined—

(1) after the application of section 824(d) without regard to paragraph (1)(E) thereof, and

(2) without regard to amounts remaining in the account which were added, with respect to all taxable years, under section

824(a)(1)(C) (relating to additional deduction to provide protection against losses for certain companies having concentrated windstorm, etc., risks).

Under paragraph (2) of the new section 824(d), for purposes of determining the ceiling on the protection against loss account in the case of a company having concentrated windstorm, etc., risks, any amount added to the account by reason of the application of section 824(a)(1)(C) is not to be taken into account.

Paragraph (3) of the new section 824(d) provides rules relating to the priority in which the subtractions from the protection against loss account are to be made. Under paragraph (3)(A) of the new section 824(d) the amounts required to be subtracted from the protection against loss account under section 824(d)(1) (A), (B), and (C), are to be made—

(1) first (on a first-in, first-out basis) from amounts in the account with respect to the 5 preceding taxable years and the taxable year, and

(2) then from amounts in the account with respect to earlier years.

Under paragraph (3)(B) of the new section 824(d), the amounts required to be subtracted from the protection against loss account under section 824(c)(1)(E) are to be subtracted only from amounts in the account with respect to the taxable year.

Under paragraph (3)(C) of the new section 824(d), if the amount to be subtracted from the total amounts in the account with respect to any taxable year is less than such total, the amount required to be subtracted from the protection against loss account under section 824(d)(1) (A), (B), (C), and (E) is to be subtracted from each of the amounts referred to in section 824(a)(1) in the account with respect to such year in the proportion which each bears to the total amount in the account with respect to such year. For example, assume that for the taxable year 1966, N, a mutual insurance company subject to the tax imposed by section 821(a), is required to subtract $60 from its protection against loss account under section 824(d)(1) (other than under subpar. (E)). Assume that the total amount in the account for 1963 (the first preceding taxable year for which additions to the account were made) is $100. Assume further that of this $100 balance, $30 is due to the application of section 824(a)(1)(A), $50 is due to the application of section 824(a)(1)(B), and $20 is due to the application of section 824(a)(1)(C). Under paragraph (3)(C) of the new section 824(d), since the amount to be subtracted from the balance in the account with respect to 1963 is less than such balance, the amount to be subtracted from each of the amounts in the account with respect to such taxable year shall be in the proportion which each bears to such total. Accordingly, the amount in the account by reason of the application of section 824(a)(1)(A) shall be reduced by $18 (30/100×$60). The amount in the account with respect to the application of section 824(a)(1)(B) shall be reduced by $30 (50/100×$60). The amount in the account with respect to the application of section 824(a)(1)(C) shall be reduced by $12 (20/100×$60).

Paragraph (4) of the new section 824(d) provides that if the taxpayer is not subject to tax under part II of subchapter L for any taxable year, the entire amount in the protection against loss account at the close of the preceding taxable year is to be subtracted from the account

in such preceding taxable year and included in mutual insurance company taxable income (as defined in sec. 821(b)) for such preceding taxable year.

Paragraph (5) of the new section 824(d) provides that for any taxable year for which the company is subject to the tax imposed by section 821(a), it may elect to subtract from its protection against loss account any amount which, except for the application of this election, would be in such account as of the close of such taxable year. The amount elected to be subtracted from the protection against loss account is to be included in mutual insurance company taxable income (as defined in sec. 824(b)) for the taxable year. The election must be made after the close of the taxable year for which it is to apply and not later than the time prescribed by law for filing the return (including extensions thereof) for the taxable year following such taxable year, and in such manner and form as the Secretary or his delegate may by regulations prescribe. The election is to apply only with respect to the taxable year for which it is made and once such an election has been made it may not subsequently be revoked.

Paragraph (6) of the new section 824(d) defines the term "underwriting loss" for purposes of determining the amount of the subtractions required to be made under section 824(d)(1) (A) and (B). The term means the amount by which—

(1) the deductions which would be taken into account in computing taxable income under section 832 if the taxpayer were subject to the tax imposed by section 831, reduced by the sum of—

(A) the deductions provided in section 822(c) (relating to deductions in computing taxable investment income), and

(B) the deduction for dividends to policyholders provided by section 832, exceeds

(2) the amount referred to in section 823(a)(1)(A).

Examples.—The application of the new section 824(d) may be illustrated by the following examples:

Example (1): For the taxable year 1969, X, a mutual insurance company subject to the tax imposed by section 821(a), has a statutory underwriting loss of 22, including dividends to policyholders of 20 and a protection against loss deduction of 7 (which is entirely attributable to the application of section 824(a)(1)(A)). The following table shows the protection against loss account of X before and after the application of section 824(d) for the taxable year 1969:

	1963	1964	1965	1966	1967	1968	1969
Protection against loss account:							
Balance remaining in account with respect to each taxable year (before application of sec. 824(d)	3	2	4	5	4	3	7
Balance remaining in account with respect to each taxable year (after application of sec. 824(d))	3	0	0	0	0	0	3

Under the provisions of section 824(d)(1)(A), X would subtract 22 (the amount by which the statutory underwriting loss exceeds the underwriting loss, or 22 minus 0) from its protection against loss account for the taxable year 1969. Under the provisions of section

824(d)(3)(A), since the subtractions are to be made with respect to amounts in the account for the 5 preceding taxable years and the taxable year on a first-in, first-out, basis, X would first apply the amount to be subtracted to the amounts in the account with respect to 1964, 1965, 1966, 1967, and 1968, in that order. This would reduce the total amount in the account with respect to such taxable years by 18, and the balance in the account with respect to each of the taxable years 1964 through 1968 would be reduced to zero. The remaining amount required to be subtracted under section 824(d)(1)(A), 4 (22 minus 18), would then be subtracted from the amount added to the account for the taxable year, 7 (an amount equal to the protection against loss deduction for the taxable year 1969), leaving a balance of 3 (7 minus 4) in the account with respect to 1969. No proration of the subtraction from the amount in the account for 1969 is required under section 824(d)(3)(C) since the entire amount added to the account in 1969 was added by reason of section 824(a)(1)(A).

Example (2): Assume the facts are the same as in example (1), except that X has a statutory underwriting loss of 27 for the taxable year 1969. After the application of section 824(d) for the taxable year 1969, the results would be as follows:

Protection against loss account

	1963	1964	1965	1966	1967	1968	1969
Balance remaining in account with respect to each taxable year (after application of sec. 824(d))	1	0	0	0	0	0	0

Under the provisions of section 824(d)(1)(A), X would subtract 27 (the amount by which the statutory underwriting loss exceeds the underwriting loss, or 27 minus 0) from its protection against loss account for the taxable year 1969. This subtraction would be made (on a first-in, first-out, basis) under section 824(d)(3)(A)(i) from amounts in the account with respect to 1964, 1965, 1966, 1967, 1968, and 1969, in that order. This would reduce the total amount in the account with respect to such taxable years by 25, and the balance in the account with respect to each of the taxable years 1964 through 1969 would be reduced to zero. Under the provisions of section 824(d)(3)(A)(ii), the remaining amount required to be subtracted under section 824(d)(1)(A), 2 (27 minus 25), would then be subtracted from the amount in the account with respect to 1963 (i.e., the amount representing one-half of the amount added by reason of section 824(a)(1)(B) which was not required to be subtraced from the protection against loss account under section 824(d)(1)(D) in 1968). Thus, the amount in the account with respect to 1963 would be reduced to 1 (3 minus 2).

Example (3): Assume that Y, a mutual insurance company subject to tax under section 821(a), has a protection against loss account which reflects the following additions for the taxable years 1963 through 1968:

Additions to protection against loss account

	1963	1964	1965	1966	1967	1968
Additions:						
1 percent of losses incurred	15	20	60	60	60	60
25 percent of underwriting gain	60	20	40	50	45	45
Additional deduction for concentrated risks	0	0	5	5	0	0
Total	75	40	105	115	105	105

Y, in computing mutual insurance company taxable income for 1968, is required to subtract from the account with respect to 1963 the entire amount of the 1 percent of losses incurred added for 1963 (15) and one-half of the underwriting gain (30) added for such year. Upon taking into account these subtractions, the balance in the protection against loss account with respect to 1963 is 30 (the one-half remaining in the account after the application of paragraph (1)(D) of section 824(d)).

Assume further, that for the taxable year 1969, Y has taxable investment income of 50, underwriting gain of 80, incurred losses of 5,000, and premiums earned less dividends to policyholders of 5,080. Under section 824(a), the protection against loss deduction for 1969 is 60. After applying section 824(c), but before applying section 824(d) for 1969, the protection against loss account as of the close of 1969 (after subtracting in 1968 the 45 amount with respect to 1963) would be as follows:

Protection against loss account

	1963	1964	1965	1966	1967	1968	1969
Additions:							
1 percent of loss incurred	0	20	60	60	60	60	40
25 percent of underwriting gain	30	20	40	50	45	45	20
Additional deduction for concentrated risks	0	0	5	5	0	0	0
Total with respect to taxable year	30	40	105	115	105	105	60
Total (as of end of each year before 1969 subtractions)	30	70	175	290	395	500	560

After making the addition to the protection against loss account for 1969 and obtaining the results shown in the table above, Y is required to make the subtractions for 1969 from the account. These subtractions may be summarized as follows:

Subtractions under sec. 824(d) for 1969

Taxable year with respect to which amount is subtracted	1963	1964	1965	1966	1967	1968	1969
Par. (1)(A) subtraction	0	0	0	0	0	0	0
Par. (1)(B) subtraction	0	0	0	0	0	0	0
Par. (1)(C) subtraction	0	0	0	0	0	0	0
Par. (1)(D) subtraction	0	[1] 30	0	0	0	0	0
Par. (1)(E) subtraction	0	0	0	0	0	0	12
Pars. (4) and (5) subtraction	0	0	0	0	0	0	0

[1] $20 represents the amount added for 1964 with reference to incurred losses; $10 represents one-half of the amount added for 1964 with reference to underwriting gain.

After determining the subtractions with respect to years before 1969, the next step is to determine whether any subtraction is required for the taxable year 1969 under section 824(d)(1)(E). Since the total balance in the account after the application of section 824(d) (other than paragraph (1)(E) thereof), 520 (560 minus 30, and excluding 10 added to the account by reason of the additional deduction for protection against losses for concentrated windstorm, etc., companies provided by section 824(a)(1)(C)), exceeds 10 percent of premiums earned on insurance contracts during the taxable year less dividends to policyholders, 508 (10 percent of 5,080), Y would be subject to the ceiling on the protection against loss account for the taxable year 1969 and would be required to subtract 12 (the excess of 520 over 508) from the account under section 824(d)(1)(E). Under the provisions of section 824(d)(3)(B) this subtraction would be made only from amounts in the account with respect to the taxable year. 1969. Under the provisions of section 824(d)(3)(C), however, since the amount to be subtracted, 12, is less than the total amount added to the account for the taxable year, 60 (40 plus 20), the subtractions under section 824(d)(1)(E) would be applied ratably against each of the amounts added to the account for the taxable year. Thus, the amount remaining in the account with respect to section 824(a)(1)(A) for the taxable year 1969, would be 32 (40 minus 40/60 × 12, or 40 minus 8), and the amount remaining in the account with respect to section 824(a)(1)(B) for the taxable year 1969, would be 16 (20 minus 20/60 × 12, or 20 minus 4).

Based on these facts, Y's mutual insurance company taxable income for 1969 would be 112 (the sum of taxable investment income of 50, plus statutory underwriting income of 20 (underwriting gain minus protection against loss deduction, or 80 minus 60), plus subtractions from the protection against loss account under section 824(d) of 42).

SECTION 825. UNUSED LOSS DEDUCTION

(*a*) *Amount of deduction.*—Subsection (a) of the new section 825 provides that, for purposes of part II of subchapter L, the unused loss deduction (used in the determination of mutual insurance company taxable income under section 821(b)) shall be an amount equal to the unused loss carryovers and carrybacks to the taxable year.

(*b*) *Unused loss defined.*—Subsection (b) of the new section 825 defines the term "unused loss," for purposes of part II of subchapter L, as the amount by which—

(1) the sum of the statutory underwriting loss (as defined in sec. 823(a)(2)) and the investment loss (as defined in sec. 822(a)(2)), exceeds—

(2) the sum of—

(A) the taxable investment income (as defined in sec. 822(a)(1)),

(B) the statutory underwriting income (as defined in sec. 823(a)(1)), and

(C) the amounts required to be subtracted from the protection against loss account under section 824(d).

If the sum of the items under (1) does not exceed the sum of items under (2), the unused loss is zero.

(*c*) *Loss year defined.*—Subsection (c) of the new section 825 defines as the loss year, for purposes of part II of subchapter L, any taxable year in which a company subject to the tax imposed by section 821(a) has an unused loss which is more than zero.

(*d*) *Years to which carried.*—Subsection (d) provides that the unused loss for any loss year is to be an unused loss carryback to each of the 3 taxable years preceding the loss year and an unused loss carryover to each of the 5 taxable years following the loss year. For certain taxable years to or from which an unused loss may not be carried, see section 825(g).

(*e*) *Amount of carrybacks and carryovers.*—Subsection (e) of the new section 825 provides that for any loss year, the entire amount of the unused loss, determined under the provisions of section 825(b), shall be carried to the earliest of taxable years to which such loss may be carried under section 825(d) (subject to the limitations of section 825(g)). The amount of the unused loss permitted under section 825(d), carried under section 825(d) to each of the other taxable years, following the earliest taxable year shall be the excess of such loss over the sum of the offsets for each taxable year preceding the taxable year to which the loss is carried.

(*f*) *Offset defined.*—Subsection (f) of the new section 825 defines the term "offset," for purposes of section 824(e) and provides that the taxable year to which an unused loss is carried is to be referred to as the "offset year." "Offset" is defined as the mutual insurance company taxable income for the offset year in the case of an unused loss carryback from the loss year to the offset year. In the case of an unused loss carryover from the loss year to the offset year, the offset is the sum of the amount required to be subtracted from the protection against loss account under section 824(d)(1)(C) for the offset year and the mutual insurance company taxable income for the offset year. For purposes of computing the offset, the mutual insurance company taxable income for the offset year (as defined in section 821(b)) shall be determined without regard to any loss carryback or carryover to the offset year from the loss year, or any year thereafter.

Example: The application of section 825 may be illustrated by the following example:

For the taxable year 1967, F, a mutual insurance company subject to the tax imposed by section 821(a), has the following items:

Taxable investment income	1
Underwriting loss	59
Addition to protection against loss account	8
Dividends to policyholders	0
Statutory underwriting loss	67

As explained below, the subtractions from protection against loss account are as follows:

Amount subtracted from amounts in account with respect to taxable years 1963 through 1966	18
Amount subtracted from amounts in account with respect to taxable year 1967	8
Total subtractions from protection against loss account under sec. 824(d)	26

The application of section 825 in this case may be illustrated by the facts and results shown in the following table and explained below:

	Taxable year—					
	1963	1964	1965	1966	1967	1968
Protection against loss account:						
Addition to account during taxable year	6	2	3	7	8	7
Subtraction from account during taxable year	0	0	0	0	8	7
Protection against loss account (at end of year)	6	2	3	7	0	0
Protection against loss account (at end of taxable year 1968)	0	0	0	0	0	0
Unused loss	0	0	0	0	40	0
Unused loss carryback	0	40	35	25	0	0
Unused loss carryover	0	0	0	0	0	18
Unused loss deduction	0	40	35	25	0	18
Mutual insurance company taxable income (computed without regard to unused loss)	13	5	10	7	0	2
Mutual insurance company taxable income (computed with regard to unused loss)	13	0	0	0	0	0
Offset for year	0	5	10	7	0	9
Offset total	0	5	15	22	0	31

1967: Under the provisions of section 825(b), F's unused loss for 1967 is 40, the amount by which the sum of the statutory underwriting loss and the investment loss, 67 (67 plus 0), exceeds the sum of the taxable investment income, the statutory underwriting income, and the amounts required to be subtracted from the protection against loss account under section 824(d) for the taxable year, 27 (the sum of 1, 0, and 26, respectively).

1967 carryback to 1964: Under the provisions of section 825(e), the entire unused loss for 1967 of 40 is carried back to 1964, the earliest year to which the loss may be carried under section 825(d). Since there are no other amounts carried to 1964, the unused loss deduction for 1964 is 40. Thus, after taking the unused loss deduction into account, the mutual insurance company taxable income for 1964 is zero, and the offset for 1964 is 5 (the mutual insurance company taxable income for 1964 determined without regard to the unused loss carryback from 1967 or any year thereafter).

1967 carryback to 1965: The portion of the unused loss for 1967 which is carried back to 1965 is 35 (40 minus 5, the offset for 1964). After taking the underwriting loss deduction into account, the mutual insurance company taxable income for 1965 is zero. The offset for 1965 is 10, the mutual insurance company taxable income for 1965 determined without regard to any unused loss carryback or carryover from 1967 or any year thereafter.

1967 carryback to 1966: The portion of the unused loss for 1967 which is carried back to 1966 is 25. This amount is the excess of the underwriting loss for 1967 of 40 over the sum of the offset for 1965 (5) and the offset for 1966 (10). Thus, as a result of the unused loss for 1967, the mutual insurance company taxable income for 1966 is reduced to zero. The offset for 1966 is 7.

1967 carryover to 1968: Under the provisions of section 825(d), the portion of the unused loss for 1967 which is carried forward to 1968 is 18 (40 minus the sum of 10, 5, and 7, the offsets for 1964, 1965, and 1966, respectively). Under section 825(f)(2), this amount is first applied against any amounts in the protection against loss account at the end of 1968, and is then applied against the mutual insurance

company taxable income for 1968. Thus, assuming that there are no other subtractions from its protection against loss account under section 824(d) for 1968, F's protection against loss account of 7 is reduced to zero by reason of the subtraction under section 824(d)(1)(C). The remaining portion of the unused loss for 1967 which is carried to 1968, 11 (18 minus 7, the amount of the unused loss carryover to 1968 which is subtracted from the protection against loss account under sec. 824(d)(1)(C)), is then applied against the mutual insurance company taxable income for 1968. Thus, after the application of the unused loss deduction for 1968, the mutual insurance company taxable income for 1968 is zero. The offset for 1968 is 9, the sum of the amount required to be subtracted from the protection against loss account under section 824(d)(1)(C) for 1968 (7), plus the mutual insurance company taxable income for 1968, determined without regard to the unused loss carryover from 1967 or any unused loss carryback from 1967 or any year thereafter (2). The remaining 9 of the unused loss for 1967 (40 minus the sum of 10, 5, 7, and 9, the offsets for 1964, 1965, 1966, and 1968, respectively) is carried forward to 1969, and to the extent not used in that year or any year thereafter, may be carried forward to 1970, 1971, and 1972, in that order.

(*g*) *Limitations.*—Subsection (g) of the new section 825 provides that, for purposes of part II of subchapter L, an unused loss (as defined in sec. 825(b)) may not be carried—

(1) to or from any taxable year beginning before January 1, 1963;

(2) to or from any taxable year for which the insurance company is not subject to tax imposed by section 821(a); nor

(3) to any taxable year if, between the loss year and such taxable year, there is an intervening taxable year for which the insurance company was not subject to the tax imposed by section 821(a).

Examples.—The application of section 825(g) may be illustrated by the following:

Example (1.)—For the taxable year 1963, M, a mutual insurance company subject to tax imposed by section 821(a), has an unused loss (as defined in sec. 825(b)) of $65,000. The loss may not be carried back to any taxable year beginning before 1963. However, the loss may be carried forward to each of the 5 taxable years following 1963 provided that for each of such succeeding taxable years M is subject to the tax imposed by section 821(a).

Example (2.)—Assume the facts are the same as in example (1), except that for the taxable year 1964, the gross amount received by M from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) exceeds $75,000 but does not exceed $300,000. If M does not make the election under section 821(d) (relating to election to be taxed under sec. 821(a) for 1964), the loss will not be allowed as an unused loss carryover since, by reason of section 825(g)(3), the unused loss may not be carried to any taxable year if, between the loss year and such taxable year, there is an intervening taxable year for which the insurance company was not subject to the tax imposed by section 821(a), and by reason of section 825(g)(1), the unused loss may not be carried to any taxable year beginning before 1963.

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SECTION 826. ELECTION BY RECIPROCAL

(*a*) *In general.*—Subsection (a) of the new section 826 provides that, except as provided in section 826(c), any insurance company which is an interinsurer or reciprocal underwriter (referred to in sec. 826 as a "reciprocal") subject to the tax imposed by section 821(a), may elect to be subject to the limitation provided in subsection (b) of the new section 826. Such election shall be made, under regulations prescribed by the Secretary or his delegate, not later than the time prescribed by law (including extensions thereof) for filing the return for the year for which such election is first to apply. The election is to apply for the taxable year for which made and for all succeeding taxable years and may not be revoked without the consent of the Secretary or his delegate. The effect of such election is to increase the income of the reciprocal by the income of its attorney-in-fact attributable to the reciprocal for purposes of computing the taxes imposed by section 821(a) and to allow such reciprocal a credit for the taxes paid by the attorney-in-fact with respect to the income attributed to the reciprocal.

(*b*) *Limitation.*—Subsection (b) of the new section 826 provides that a reciprocal making the election provided under section 826(a) shall limit the deduction for amounts paid or incurred in the taxable year to the attorney-in-fact to such amounts as are deductible by the attorney-in-fact in respect of the income received by the attorney-in-fact from the reciprocal. In no case may such deduction of the reciprocal be increased by the deductions of the attorney-in-fact allocable to the income received from the reciprocal.

(*c*) *Exception.*—Section 826(c) provides that no election under section 826(a) may be made by a reciprocal unless its attorney-in-fact—

(1) is a corporation subject to the taxes imposed by section 11 (b) and (c) of subtitle A;

(2) consents to make available such information as may be required during the period in which an election made under subsection (a) is in effect;

(3) reports income received from the reciprocal and deductions allocable thereto under the same method of accounting used by the reciprocal in reporting deductions for amounts paid or incurred to the attorney-in-fact; and

(4) files its return on a calendar year basis.

(*d*) *Special rule.*—Subsection (d) of the new section 826 provides that the limitation under section 826(b) shall not be taken into account by any reciprocal electing under section 826(a) for purposes of computing the protection against loss deduction provided in section 824(a) and for purposes of computing the addition to the protection against loss account provided in section 824(c). Thus, in effect, a reciprocal making the election shall not take into account any of the income of the attorney-in-fact for purposes of computing its protection against loss deduction.

(*e*) *Credit.*—Subsection (e) of the new section 826 provides that any reciprocal electing to be subject to the limitation provided in subsection (b) shall be credited with the tax paid by its attorney-in-fact with respect to the income of the reciprocal in such taxable year.

(*f*) *Surtax exemption denied.*—Subsection (f) of the new section 826 provides that any tax imposed upon the increase in the income of the reciprocal attributable to the limitation under subsection (b) shall be computed without regard to the $25,000 surtax exemption provided in section 821(a)(2).

(*g*) *Adjustment for refund.*—Subsection (g) of the new section 826 provides that if for any taxable year an attorney-in-fact is allowed a credit or refund for taxes paid with respect to which a reciprocal was allowed a credit or refund under subsection (e) of the new section 826, the taxes of the reciprocal for the year in which such credit or refund is allowed shall be properly adjusted under regulations prescribed by the Secretary or his delegate. This adjustment prevents the reciprocal and the attorney-in-fact from obtaining a credit or refund with respect to the same tax.

For example, assume that a reciprocal has elected in 1963 to be subject to the limitation provided in section 826(b) and such election is still in effect in taxable year 1966. Assume further that in taxable year 1969 its attorney-in-fact receives a refund or credit with respect to taxable year 1966. In such case, the taxes of the reciprocal in taxable year 1969 shall be properly adjusted under regulations prescribed by the Secretary or his delegate.

(*h*) *Taxes of attorney-in-fact unaffected.*—Subsection (h) of the new section 826 provides that nothing in section 826 shall either increase or decrease the taxes imposed by chapter 1 on the income of the attorney-in-fact.

Example.—The application of section 826 may be illustrated by the following example:

For the taxable year 1963, R, a reciprocal underwriter subject to the taxes imposed by section 821(a), has the following items (determined before applying any election under sec. 826):

Gross income under sec. 832		578
Gross investment income		50
Deductions under sec. 832 (as modified by sec. 823(b)):		
Deduction for amounts paid by R to attorney-in-fact A	100	
All other deductions	500	
Total deductions under sec. 832	600	
Deductions under sec. 822(c)		40
Incurred losses		400
Protection against loss deduction		4
Underwriting gain		0
Mutural insurance company taxable income		0
Unused loss		22
Credit or refund for taxes paid		0

Assume that the deductions of attorney-in-fact A allocable to the income received by A from R are 60 and the tax paid by A allocable to the income received from R is 16. If R elects to be subject to the

limitation provided in section 826(b), the results for 1963 would be as follows:

Gross income under sec. 832		578
Gross investment income		50
Deductions under sec. 832 (as modified by sec. 823 (b)):		
Deduction for amounts paid by R to attorney-in-fact A	60	
All other deductious	500	
Total deductions under sec. 832	560	
Deductions under sec. 822(c)		40
Incurred losses		400
Protection against loss deduction		4
Underwriting gain		8
Mutual insurance company taxable income		14
Unused loss		0
Credit or refund for taxes paid		16

Under the provisions of section 826(b), R's deduction for amounts paid or incurred to the attorney-in-fact in the taxable year 1963 would be limited to the deductions of A allocable to the income received by A from R. Thus, R's deductions under section 832 (as modified by sec. 823(b)) for 1963 would be 60 (the deductions of A which are allocable to the income received by A from R). As a result of making the election under section 826(a) for the taxable year 1963, R's underwriting gain would be 8, and its statutory underwriting income would be 4 (the underwriting gain of 8 minus the protection against loss deduction under section 824(a)(1)(A) representing 1 percent of losses incurred of 4, or 8 minus 4). Accordingly, R's mutual insurance company taxable income for 1963 would be 14. This amount consists of the taxable investment income of 10 (gross investment income minus deductions under sec. 822(c), or 50 minus 40) plus the statutory underwriting income of 4. Since all of R's mutual insurance company taxable income of 14 is attributable to the limitation under section 826(b), the entire amount is subject to the surtax under section 821(a)(2) without regard to the $25,000 surtax exemption. The credit of 16, representing that part of the taxes paid by A which is allocable to the income received by A from R, may be applied by R against its taxes with respect to its mutual insurance company taxable income of 14 for 1963, and R would be entitled to a refund of any excess of the amount of such credit over its tax liability for 1963.

SECTION 10. MUTUAL INSURANCE COMPANIES (OTHER THAN LIFE, MARINE, AND CERTAIN FIRE INSURANCE COMPANIES), ETC. (Continued)

(*d*) *Mutual fire insurance companies operating on basis of premium deposits.*—Subsection (d) of section 10 of the bill amends section 831(a) of the 1954 Code to include mutual fire insurance companies operating on the basis of premium deposits among the companies which are subject to the tax imposed by part III of subchapter L of chapter 1 of the code.

(*1*) *Application of section 831(a).*—Subsection (d)(1) of section 10 of the bill amends section 831(a) of the code (which imposes a tax on certain mutual marine and mutual fire insurance companies and on stock insurance companies which are not life insurance companies)

to provide that, for taxable years beginning after December 31, 1962, mutual fire insurance companies operating on the basis of premium deposits are to be subject to tax under part III of subchapter L. Under existing law, mutual fire insurance companies operating on the basis of premium deposits (the so-called factory mutual insurance companies) are taxed in the same manner as any other mutual insurance company (other than a life or marine or fire insurance company issuing perpetual policies). Thus, these companies are subject to the tax imposed by section 821. (See *Philadelphia Manufactures Mutual Insurance Company* v. *Commissioner* (1959), 33 T.C. 490, aff'd (C.A. 3d 1960) 284 F. 2d 296.) Under the bill, every mutual fire insurance company whose principal business is the issuance of policies for which the premium deposits are the same, regardless of the length of the term for which the policies are written, will be subject to the tax imposed by section 831(a) if the unabsorbed portion of such premium deposits not required for losses, expenses, or establishment of reserves is returned or credited to the policyholder on cancellation or expiration of the policy.

(*2*) *Treatment of unabsorbed premium deposits.*—Subsection (d)(2) of section 10 of the bill amends section 832(b)(4) of the code (relating to definition of premiums earned) to provide that for purposes of determining the premiums earned on insurance contracts during the taxable year in the case of a mutual fire insurance company operating on the basis of premium deposits, the term "unearned premiums" means (with respect to the policies described in section 831(a)(3)(B)) the amount of unabsorbed premium deposits which the company would be obligated to return to its policyholders at the close of the company's taxable year if all of such policies were terminated at such time. This paragraph further provides that for purposes of determining the amount which such company would be obligated to return to its policyholders at the close of any taxable year, the company must use its own schedule of unabsorbed premium deposit returns then in effect.

(*3*) *Conforming amendments.*—Subparagraph (d)(3) of section 10 of the bill amends section 832(b)(1)(C) of the code (relating to definition of gross income) to conform to the amendment to section 831(a).

(*4*) *Adjustment of premium deposit.*—Subparagraph (d)(4) of section 10 of the bill amends section 832(c)(11) of the code (relating to deduction for dividends to policyholders) to provide that the term "dividends and similar distributions" includes amounts returned or credited to policyholders on cancellation or expiration of factory mutual policies described in the new section 831 (a)(3)(B).

(*5*) *Additional item of income.*—Subparagraph (d)(4) of section 10 of the bill amends section 832(b)(1) of the code (relating to the definition of gross income) to provide that, in the case of a mutual fire insurance company operating on the basis of premium deposits, gross income includes an amount which is equal to 2 percent of premium earned on insurance contracts during the taxable year with respect to policies described in section 831(a)(3)(B) after deduction of premium deposits returned or credited during the same taxable year. The term premiums earned on insurance contracts during the taxable year for purposes of this section means the absorbed premiums for the taxable year determined in accordance with the schedule of unabsorbed premium deposits in effect at the end of the taxable year.

(*e*) *Election of certain mutual companies to be taxed on total income.*—Subsection (e) of section 10 of the bill amends section 831 of the code (relating to tax on insurance companies (other than life or mutual), mutual marine insurance companies, and mutual fire insurance companies issuing perpetual policies) by redesignating subsection (c) as subsection (d) and adding a new subsection (c). The new section 831(c) provides that any mutual insurance company engaged in writing marine, fire, and casualty insurance which for any 5-year period beginning after December 31, 1941, and ending before January 1, 1962, was subject to the tax imposed by section 831 (or the tax imposed by corresponding provisions of prior law) may elect to be subject to the tax imposed by section 831, whether or not marine insurance is its predominant source of premium income. If such election is made, the electing company shall be subject to the tax imposed by section 831, for years beginning after December 31, 1961, rather than subject to the tax imposed by section 821. Such election shall not be revoked except with the consent of the Secretary or his delegate.

(*f*) *Technical amendments, etc.*—This subsection makes certain technical changes to provisions of the 1954 Code outside of parts II or III of subchapter L to conform those provisions to the changes in subchapter L made by section 10 of the bill.

(*1*) *Credit for foreign taxes.*—Subsection (f)(1) amends section 841 of the code (providing for the allowance to an insurance company of the foreign tax credit provided in section 901) so as to define the term "taxable income," as used in section 904, to mean the mutual insurance company taxable income (as defined in sec. 821(b)) in the case of the tax imposed by section 821(a), and the taxable investment income (as defined in sec. 822(a)(1)) in the case of the tax imposed by section 821(c).

(*2*) *Adjustments to basis for depreciation sustained.*—Subsection (f)(3) amends section 1016(a)(3) of the code (relating to adjustments to basis for depreciation, etc., sustained) to provide, in effect, that any exhaustion, wear and tear, obsolescence, amortization, and depreciation, to the extent sustained (and to the extent sec. 1016(a)(2) does not apply), on property held in respect of any period since February 28, 1913, by a person subject to tax under part II of subchapter L (or the corresponding provisions of prior income tax laws), must be taken into account in determining the adjusted basis of such property.

(*3*) *Alternative tax on capital gains.*—Subsection (f)(2) amends section 1201(a) of the code (relating to alternative tax on capital gains) to conform to the amendment to section 821.

(*4*) *Clerical amendments.*—Subsection (f)(4) makes conforming changes to the table of parts for subchapter L.

(*g*) *Effective date.*—Subsection (g) of section 10 of the bill provides that the amendments made by section 10 of the bill (other than by subsec. (e)) shall apply only with respect to taxable years beginning after December 31, 1962. Section 831(c) of the code, as added by subsection (e) of section 10, is applicable for taxable years beginning after December 31, 1961.

SECTION 11. DOMESTIC CORPORATIONS RECEIVING DIVIDENDS FROM FOREIGN CORPORATIONS

Section 11 of the bill deals with the method to be used for determining the amount of foreign income tax deemed to have been paid by domestic corporations with respect to dividends received from foreign corporations for purposes of allowance of a foreign tax credit under section 902 of the code. The bill amends the formulas of subsections 902 (a) and (b), redefines the term "accumulated profits" in section 902(c), and requires (under a new sec. 78) the inclusion of taxes deemed paid in income as a dividend. It also repeals section 902(d) which provides a special rule for allowance of a foreign tax credit with respect to royalty or compensation payments made by certain wholly-owned foreign subsidiaries to domestic parents in lieu of dividends, and changes the source of income rule of section 861(a)(2)(B) with respect to dividend income received from a foreign corporation which derived income from sources within the United States and for which a dividends received deduction was allowed under section 245.

(*a*) *Entire amount of foreign tax to be taken into account.*—Subsection (a)(1) of section 11 of the bill amends the definition of accumulated profits contained in section 902(c) of the 1954 Code. Existing law defines accumulated profits as gains, profits, or income reduced by the amount of taxes with respect thereto. Under the amendment, however, accumulated profits are defined as gains, profits, or income computed without reduction by the amount of the income, war profits, and excess profits taxes imposed by a foreign country or possession of the United States on or with respect to such profits or income. Taxes imposed by the United States will, however, continue to reduce such accumulated profits.

By redefining accumulated profits, the effect of the amendment is to increase the amount of taxes to be taken into account in applying the proportions provided in sections 902 (a) and (b) of the code. Under existing law, a credit is allowed to a domestic corporation for all or a part of the foreign taxes paid on or with respect to the accumulated profits of the foreign corporation making a distribution. However, by the existing definition, accumulated profits are total profits less taxes thereon. The Supreme Court, in *American Chicle Co.* v. *United States*, 316 U.S. 450 (1942), has held that the amount of tax paid on or with respect to a foreign corporation's accumulated profits is the same proportion of total taxes on profits as accumulated profits is of total profits. Thus, if a corporation had total profits of $100, foreign taxes of $40, and therefore accumulated profits of $60, the amount of taxes paid on or with respect to accumulated profits would be $24 ($40×$60/100). If the accumulated profits of $60 were paid as a dividend, no more than $24 could be allowed as a credit as deemed paid under section 902 (a) or (b).

As amended, the section 902(c) definition will permit the taking into account of a stated proportion of total taxes. It is no longer necessary to apply the *American Chicle* rule. Since accumulated profits would be total profits without reduction for taxes paid thereon, the amount of taxes paid on or with respect to accumulated profits would, in the above example, be $40 rather than $24.

Subsection (a)(2) of section 11 of the bill makes conforming amendments to the existing subsections (a) and (b) of section 902 to provide for the use of the proportion which distributed dividends bear to the accumulated profits in excess of foreign taxes. The result is to continue under such subsections the use of the ratios under existing law, but because of the amendment to section 902(c) the amount against which the ratios operate is increased.

The application of these changes in a section 902(a) computation may be illustrated by the following example involving Corporation P, a domestic corporation which owns 100 percent of the voting stock of Corporation FC, a foreign corporation. It is assumed that all transactions have taken place within, and are related to, the same taxable year.

Example (1)

(i)	Gains, profits, and income of Corporation FC	$100
(ii)	Foreign tax paid by Corporation FC with respect to such gains, profits, and income	30
(iii)	Accumulated profits of Corporation FC computed without reduction for foreign taxes (sec. 902(c))	100
(iv)	Accumulated profits of Corporation FC reduced by foreign taxes (sec. 902(a))	70
(v)	Dividends paid by Corporation FC to Corporation P	35
(vi)	Corporation P is deemed to have paid the same proportion of the total tax paid by Corporation FC as dividends, determined without regard to section 78, bear to accumulated profits in excess of taxes: $\$30 \times 35/70$	15

Example (1) will apply to all dividends received by a domestic corporation after December 31, 1964, regardless of the year in which the profits from which such dividends were paid were accumulated. Example (1) will also apply with respect to dividends received by a domestic corporation in its taxable years beginning after December 31, 1962, so long as the dividends from the foreign corporation are attributable to accumulated profits of the foreign corporation for its taxable years beginning after December 31, 1962. However, for periods before January 1, 1965, the *American Chicle* rule and the present 902(a) treatment will continue to apply where the dividends from the foreign corporation are attributable to accumulated profits for taxable years beginning before January 1, 1963. Following the established rule, a foreign corporation is considered to be making a distribution first from its accumulated profits for its current taxable year and then from its accumulated profits of its immediately preceding year, etc.

The following example illustrates the above rules where a dividend is distributed out of both accumulated profits for taxable years beginning after December 31, 1962, and accumulated profits for taxable years beginning before January 1, 1963. The facts are the same as in example (1) except for the noted differences:

Example (2)

(i)	Gains, profits, and income of Corporation FC in 1963		$100
(ii)	Foreign tax paid by Corporation FC with respect thereto		40
(iii)	1962 accumulated profits and foreign tax:		
	Accumulated profits (existing sec. 902(c))		60
	Foreign tax		40
(iv)	Dividends paid by Corporation FC to Corporation P in 1963 and the year to which such dividends are attributable:		
	1963	$60	
	1962	30	
			90
(v)	Corporation P is deemed to have paid a foreign tax with respect to the 1963 accumulated profits of Corporation FC computed in the same manner as in example (1) ($\$40 \times 60/60$)		40
(vi)	Corporation P is deemed to have paid a foreign tax with respect to the 1962 accumulated profits of Corporation FC in the same manner as existing rules ($\$40 \times 60/100 \times 30/60$)		12
(vii)	Total foreign tax Corporation P is deemed to have paid ((v) + (vi))		52

Section 902 as amended by section 11 of the bill, when applied to dividends received after December 31, 1964, will not be affected by the fact that there may have been in an earlier year a partial distribution of accumulated profits to which the *Chicle* rule applied. For example, if a wholly-owned foreign subsidiary of a domestic corporation had total profits of $100, upon which foreign taxes of $40 had been paid, accumulated profits under existing law would be $60. Under the *Chicle* rule the taxes paid with respect to the accumulated profits would be $24 ($\$40 \times \$60/100$). Upon a distribution of one-half ($30) of such accumulated profits the domestic parent would be entitled under existing section 902(a) to a maximum credit of $12. However, if at any time after 1964, the subsidiary distributes another dividend, $30, with respect to the accumulated profits of such earlier year, and taxes deemed paid, determined in accordance with section 902(a), as amended, will be the same proportion of total taxes as the dividend bears to accumulated profits in excess of foreign taxes. Thus, the total tax of $40 would be multiplied by the fraction 30/60 and the parent would be entitled under section 902(a) as amended to a credit of $20. No account is to be taken of the foreign tax of $8 which, because of the *Chicle* rule, was not taken into account in the earlier dividend year.

The new rules effective under section 902(a) will be also effective under section 902(b). Thus, if a dividend from a foreign corporation is distributed out of its accumulated profits for a taxable year beginning after 1962, and such accumulated profits are composed in whole or in part of dividends which were received from accumulated profits of a foreign subsidiary of the foreign corporation accumulated in taxable years beginning after 1962, the new rules will be effective both under subsections (a) and (b). After 1964 the new rules will apply to subsections (a) and (b) of section 902 whether the distributions are from accumulated profits of the foreign corporation and its foreign subsidiary for their taxable years beginning after 1962 or before 1963. The computation involving these rules may be illustrated by the following example involving Corporation P, a domestic corporation which owns 100 percent of the voting stock of foreign Corporation FC which in turn owns 100 percent of the voting stock of foreign subsidiary FS. It is assumed that all transactions have taken place and are related to the taxable year 1963.

Example (3)

(A) Application of amended section 902(b) to determine tax deemed to be paid by Corporation FS:

(i)	Gains, profits, and income of Corporation FS	$100
(ii)	Foreign tax paid by Corporation FS with respect to such gains, profits, and income	20
(iii)	Accumulated profits in excess of taxes of Corporation FS: $100 less $20	80
(iv)	Dividends paid by Corporation FS to Corporation FC	40
(v)	Corporation FS foreign tax which is deemed paid by Corporation FC: $20×40/80	10

(B) Application of amended section 902(a) to determine tax deemed to be paid by Corporation P:

(i)	Gains, profits, and income of Corporation FC:	
	Business profits	$100
	Dividends from Corporation FS	40
		140
(ii)	Foreign tax paid by Corporation FC with respect to its gains, profits, and income	40
(iii)	Accumulated profits in excess of taxes paid by Corporation FC: $140 less $40	100
(iv)	Dividend paid by Corporation FC to Corporation P	80
(v)	Foreign tax paid ($40) and deemed paid ($10) by Corporation FC	50
(vi)	Foreign taxes paid and deemed paid by Corporation FC which are deemed paid by Corporation P: $50×80/100	40

Where a dividend from a foreign corporation before 1965 is attributable to its accumulated profits for a taxable year beginning after 1962, but which profits are composed in part of a dividend received by such foreign corporation from the accumulated profits of its foreign subsidiary for a taxable year or years of the subsidiary beginning before 1963, for purposes of computing the foreign tax credit a pro rata amount of the dividend received from the foreign corporation will be deemed to consist of accumulated profits of its foreign subsidiary attributable to the period before 1963. Existing law will apply to that portion of the foreign tax paid or accrued or deemed paid by the foreign corporation with respect to such pro rata amount of the dividend considered attributable to the accumulated profits of its subsidiary for taxable years before 1963 and the amendment made by section 11 of this bill will apply to the balance of such tax.

The carryback or carryover of excess foreign taxes allowable under section 904 (d) or (e) will not be affected by this section. An excess foreign tax determined in a year to which the amendments of this section do not apply may be carried over, without adjustment, to a year to which the amendments of this section apply. Conversely, foreign taxes in excess of a section 904(a) limitation in a year to which the amendments of this section apply may be carried back, without adjustment, to a year to which the amendments of this section do not apply.

See the technical explanation accompanying the amendment to section 6038 of the 1954 Code made by section 20(a) of the bill for the effect of the amendments made by section 11 of the bill on the reduction of foreign taxes caused by failure to file an information return under section 6038.

(*b*) *Inclusion in gross income of amount equal to taxes deemed paid.*—Subsection (b) of section 11 of the bill amends part II of subchapter B of chapter 1 (relating to items specifically included in income) by adding at the end thereof a new section 78. Section 78 requires a domestic corporation to include in gross income as a dividend an amount equal to the taxes deemed, as a result of section 902 (a) or (b) of the code as amended by subsection (a) of section 11 of the bill or as a result of section 957(a) (relating to taxes paid by foreign corporation) as amended by section 13 of the bill, to have been paid by the domestic corporation, if the domestic corporation chooses the benefits of the foreign tax credit. Section 78 only applies where the foreign taxes deemed to have been paid by the domestic corporation are computed under amended section 902, and it is not applicable where the taxes attributable to a particular distribution are computed under present law. Thus, in the preceding example (1) Corporation P will include $15 in gross income as a dividend. In example (2) Corporation P will include only $40 in gross income since $12 of foreign tax deemed to be paid by Corporation P is computed under existing rules. In example (3) Corporation P will include $40 in gross income.

The amount included in gross income by operation of section 78 is treated as a dividend in the same manner as a dividend actually received by the domestic corporation from a foreign corporation. For example, a section 78 dividend is included in gross income under section 61(a)(7); is personal holding company income for purposes of section 543(a)(1); and may be a portion of accumulated taxable income for purposes of section 535. However, a section 78 dividend is not a dividend for purposes of section 245 of the code (relating to deduction for dividends received from certain foreign corporations).

(*c*) *Determination of source of dividends received from certain foreign corporations.*—Subsection (c) of section 11 of the bill amends section 861(a)(2)(B) of the code by striking out "to the extent exceeding the amount of the deduction allowable under section 245 in respect of such dividends" and inserting in lieu thereof "to the extent exceeding the amount which is 100/85ths of the amount of the deduction allowable under section 245 in respect of such dividends." This restores the rule contained in section 119(a)(2)(B) of the 1939 Code, as added by the Revenue Act of 1951. The effect of the change is to establish a closer correlation between the operation of sections 245 and 861(a)(2)(B) than existing law provides.

Under present section 861(a)(2)(B), the excess of the amount of a dividend taken into account in determining the dividends received deduction under section 245 over the amount allowed as a deduction, is determined to be income from sources without the United States for purposes of the foreign tax credit provisions. As a result, 15 percent of that portion of the dividend considered as derived from sources within the United States within the meaning of section 245 is treated as income from sources within the United States for purposes of that section, but, conversely, is treated as income from sources without the United States under section 861(a)(2)(B) for foreign tax credit purposes. Subsection (c) removes this inconsistency by treating as income from sources without the United States for foreign tax credit purposes only the amount of the dividend in excess of one hundred eighty-fifths of the dividends received deduction.

(*d*) *Repeal of section 902(d).*—Subsection (d) of section 11 of the bill repeals existing section 902(d) (relating to special rules for certain wholly-owned foreign corporations).

(*e*) *Technical amendments.*—Subsection (e) of section 11 of the bill conforms the table of sections for part II of subchapter B of chapter 1 of the code to the addition of the new section 78 and adds appropriate cross references to sections 901 and 902 of the code. In addition it makes technical changes in section 535(b)(1) and 545(b)(1) to prevent the amendments made by section 11 of the bill from changing "accumulated taxable income" for purposes of the accumulated earnings tax and "undistributed personal holding company income" for purposes of the personal holding company tax and to offset the effects of section 78 whereby these incomes are increased by reason of the taxes deemed to have been paid under section 902 (a) or (b). These technical changes will allow as a deduction the taxes deemed to have been paid under sections 902 (a) and (b).

(*f*) *Effective date.*—Subsection (f) of section 11 of the bill provides that the amendments made by section 11 are to be applicable to dividends which are received by domestic corporate taxpayers in their taxable years beginning after December 31, 1962, but only to the extent that such distributions are made out of the accumulated profits of foreign corporations for their taxable years beginning after December 31, 1962. However, the amendments made by section 11 of the bill will be applicable to all dividends received by domestic corporate taxpayers from foreign corporations after December 31, 1964, regardless of the year to which the accumulated profits are attributable.

If, before 1965, the distribution from a foreign corporation for its taxable year beginning after December 31, 1962, is out of profits which are attributable to a distribution received by such foreign corporation from its foreign subsidiary, the effectiveness of the amendments depends on the taxable year to which the subsidiary's distribution is attributable. If the distribution is out of the subsidiary's accumulated profits for taxable years beginning after December 31, 1962, the amendments will be applicable. However, if the distribution is attributable to the subsidiary's accumulated profits for taxable years beginning before January 1, 1963, the present law will continue in effect.

The amendments are not applicable to a domestic corporation receiving a distribution from a foreign corporation prior to January 1, 1965, unless such distribution (1) is made out of profit of a foreign corporation accumulated in a taxable year beginning after December 31, 1962, and (2) is received by the domestic corporation in a taxable year beginning after December 31, 1962. Therefore, if for example, a foreign corporation is on a calendar year basis and it makes a distribution on November 15, 1963, out of its accumulated profits for 1963 to a domestic corporation whose taxable year began on December 1, 1962, the present law would be applicable.

SECTION 12. EARNED INCOME FROM SOURCES WITHOUT THE UNITED STATES

(*a*) *Limitation on amount and type of income excluded.*—Subsection (a) of section 12 of the bill amends section 911 of the 1954 code. This amendment retains the provisions of section 911 which require,

under certain circumstances, the exclusion of earned income from gross income of an individual who has been a bona fide resident, or is physically present, in a foreign country. However, under the amendment there will be dollar limitations on the amounts which may be excluded under section 911 by any individual. The amendment also imposes a requirement as to time of receipt and, for some purposes, attributes amounts received to the taxable year in which the services to which the amounts are attributable were performed. The amendment also provides that no amount received as a pension or annuity is excludable under section 911.

SECTION 911. EARNED INCOME FROM SOURCES WITHOUT THE UNITED STATES

(*a*) *General rule.*—Subsection (a) of section 911, as amended by section 12 of the bill, is the same as existing law in that it provides that in the case of an individual citizen of the United States—

> (1) who has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, or
>
> (2) who during any period of 18 consecutive months is present in a foreign country or countries during at least 510 full days in such period,

amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) which constitute earned income attributable to services performed during the uninterrupted period or during an 18-month period, whichever applies, may be excluded from gross income. However, the amended section 911(a) contains a new provision to the effect that the amount excluded under that provision will be computed by applying special rules contained in subsection (c). The new provision referring to the special rules in subsection (c) is in lieu of the unlimited exclusion provided by existing law with respect to bona fide foreign residence, and the $20,000-limitation with respect to physical presence in a foreign country provided by existing law. Subsection (a) also retains the provision of existing law that no deductions (other than the deductions allowed by section 151, relating to personal exemptions) will be allowed to the extent such deductions are properly allocable to or chargeable against amounts excluded from gross income under such subsection.

(*b*) *Definition of earned income.*—Subsection (b) of the amended section 911 continues, without change, the existing definition of "earned income".

(*c*) *Special rules.*—Subsection (c) of section 911, as amended by the bill, provides rules for purposes of computing the amount excludable from gross income of an individual under section 911(a).

Paragraph (1) of section 911(c) contains the limitations on the amount excludable under section 911(a). It provides, as a general rule, that the amount excluded for any taxable year is not to exceed an amount which is to be computed on a daily basis at an annual rate of $20,000. However, the annual rate is to be $35,000 in the case of an individual who qualifies as a bona fide resident of a foreign country or countries under section 911(a)(1), but only with respect to taxable years (or a portion of a taxable year) occurring immediately after

such individual has been a bona fide foreign resident for any uninterrupted period of 3 consecutive years (36 consecutive months). The amount excludable accrues on a daily basis throughout the taxable year. The number of days to be used in making the computation on a daily basis is the number of days in the taxable year for which the exclusion is claimed.

The manner of computing the amount excludable under section 911(a) on a daily basis at the prescribed annual rates may be illustrated by the following example:

Example.—A, a United States citizen, who files his returns on a calendar year basis, is privately employed and is a bona fide resident of France for the period April 1, 1963, through June 30, 1968. The amounts excludable from his gross income for the various calendar years under the provisions of section 911(a) which are computed by applying the special rules contained in section 911(c) are not to exceed the following amounts: for the year 1963, $15,068.49 (275/365×$20,000); for the year 1964, $20,000 (366/366×$20,000); for the year 1965, $20,000 (365/365×$20,000); for the year 1966, $31,301.37 (90/365×$20,000 plus 275/365×$35,000); for the year 1967, $35,000; and, for the year 1968, $17,404.37 (182/366×$35,000).

An individual who, on January 1, 1963, has been a bona fide foreign resident for an uninterrupted period in excess of 3 consecutive years is immediately entitled to the benefits of the annual rate of $35,000. An individual who returns and takes up residence in the United States is, upon resuming bona fide foreign residence, only entitled to the benefits of the annual rate of $20,000 until such individual completes another uninterrupted period of 3 consecutive years of bona fide foreign residence.

Paragraph (2) of section 911(c) provides that, for purposes of applying the limitation in paragraph (1), amounts received are to be considered received in the taxable year in which the services to which the amounts are attributable are performed. For example, amounts received during the taxable year 1965 attributable to services performed during the taxable year 1964 will, for purposes of applying the limitation in section 911(c)(1), be considered received in the taxable year 1964. Thus, if I (to whom the $20,000 limitation applies) receives $16,000 in 1964 and $7,000 in 1965, both amounts being attributable to his 1964 services, $3,000 of the $7,000 received in 1965 would be includible in his gross income for 1965.

Paragraph (3) of section 911(c) provides in effect that in applying the rules of paragraph (1), the amount excludable under section 911(a) is to be neither increased nor decreased solely by operation of community property law.

The application of the rule contained in section 911(c)(3) may be illustrated by the following examples:

Example (1).—H, a United States citizen, qualifies under section 911(a) and receives $40,000 during a taxable year for services performed abroad during such taxable year. He has been abroad for less than 3 consecutive years. W, the wife of H, earns no income of her own and continues to live in a community property state in the United States. The marital domicile also continues in such state. H and W file a joint return. The aggregate amount excludable from gross income under section 911 is $20,000. If H and W had filed

separate returns, the aggregate amount excludable under section 911 would be $20,000.

Example (2).—The facts are the same as in example (1), except that W also resides abroad. Whether H and W file their returns separately or jointly, the aggregate amount excludable under section 911 is $20,000. If W also qualifies under section 911(a) and receives $10,000 during the taxable year for services she performed abroad during such taxable year, the aggregate amount excludable under section 911 is $30,000 (whether a joint return or separate returns are filed).

Similarly, in a noncommunity property jurisdiction, if H and W both qualify under section 911(a) and receive $40,000 and $10,000, respectively, for services performed abroad during the taxable year, the aggregate amount excludable under section 911 is $30,000.

Paragraph (4) of section 911(c) establishes a requirement as to time of receipt by providing that no amount received after the close of the taxable year following the taxable year in which the services to which the amounts are attributable are performed may be excluded under section 911(a). For example, an amount received on or before the close of the taxable year 1965 which is attributable to services performed during the taxable year 1964 will satisfy the requirement as to receipt of section 911(c)(4). However, an amount received after the close of the taxable year 1965 which is attributable to services performed during the taxable year 1964 will not satisfy the requirement as to receipt of section 911(c)(4) and, therefore, will in no event be excludable under section 911(a).

Subparagraph (A) of section 911(c)(5) provides that no amount received as a pension or annuity may be excluded under section 911(a). The result is the same whether the recipient of such pension or annuity is a resident or a nonresident of the United States. Subparagraph (B) provides that no amount included in gross income by reason of section 402(b) (relating to taxability of beneficiary of non-exempt trust), section 403(c) (relating to taxability of beneficiary under a nonqualified annuity), or section 403(d) (relating to taxability of beneficiary under certain forfeitable contracts purchased by exempt organizations) may be excluded under section 911(a). Thus, amounts contributed by an employer to certain plans which do not qualify under section 401 and in which an individual has nonforfeitable rights, must be included in such individual's gross income currently. The amounts of such contributions are not excludable under section 911(a).

SECTION 12. EARNED INCOME FROM SOURCES WITHOUT THE UNITED STATES—(Continued)

(*f*) *Computation of employees' contributions*.—Existing section 72 (f)(2) of the code provides that, in the case of employees' annuities, employees' contributions include amounts contributed by the employer if such amounts would have been exempt from tax had they been paid to the employee directly. Existing law continues to apply to amounts contributed on or before December 31, 1962, for services performed on or before such date.

Subsection (b) of section 12 of the bill amends paragraph (2) of section 72(f) of the code by providing, in general, that such paragraph is not to apply to amounts which were contributed by the employer after December 31, 1962, and which would have been exempt from tax by reason of section 911 had they been paid to the employee directly. However, the preceding sentence does not apply to amounts which were contributed by the employer to provide pension or annuity credits, to the extent such credits are attributable to services performed before January 1, 1963, and are provided pursuant to pension or annuity plan provisions in existence on March 12, 1962, and on that date applicable to such services. Thus, in effect, the first sentence of the amendment contained in section 12(b) of the bill provides that an employee's basis will not be increased by reason of foreign service contributions made by an employer after December 31, 1962, and which would have been exempt from tax by reason of section 911 had they been paid to the employee directly. However, existing law would continue to apply to contributions made after December 31, 1962, to provide benefits attributable to services performed before January 1, 1963, to the extent that (1) such benefits are provided by a plan which is in existence on March 12, 1962, and (2) such contributions are required to provide the benefits set forth in the plan on March 12, 1962. Thus, certain amounts attributable to services performed before January 1, 1963, and contributed after December 31, 1962, to fund current or past service credits may be added to an employee's basis. However, to the extent benefits are initially provided after March 12, 1962, or to the extent existing benefits are increased after such date, amounts attributable to the new or increased benefits may not be added to an employee's basis even though the new or increased benefits are attributable to services performed before January 1, 1963.

(c) *Effective date.*—Subsection (c) of section 12 of the bill contains the effective date provisions applicable to the amendments to sections 911 and 72(f) of the code.

Paragraph (1) of section 12 (c) of the bill provides that, except as provided in paragraph (2), the amendments made by section 12 of the bill are to apply to taxable years ending after December 31, 1962. Paragraph (2) provides that, with respect to the changes in section 911 of the code, the amendment made by section 12(a) of the bill is to apply only with respect to amounts received after December 31, 1962, and which are attributable either, as provided in subparagraph (A), to services performed after such date, or, as provided in subparagraph (B), to services performed on or before such date, but only if on March 12, 1962, there existed no right (whether forfeitable or nonforfeitable) to receive such amounts. Thus, in effect, the effective date provision, with respect to the amendment to section 911, applies existing law to amounts received after December 31, 1962, which are attributable to services performed before January 1, 1963, if on March 12, 1962, a right existed (whether forfeitable or nonforfeitable) to receive such amounts. On the other hand, if amounts are received after December 31, 1962, which are attributable to services performed before January 1, 1963, to which the recipient did not have a right in existence on March 12, 1962, section 911, as amended by section 12 of the bill, will apply to such amounts. In the event a right to receive an amount attributable to services performed before

January 1, 1963 existed as of March 12, 1962, and thereafter such amount is increased, section 911, as amended by section 12 of the bill, will apply to such increase.

The application of the provisions of section 12(c)(2) of the bill may be illustrated by the following examples:

Example (1).—A, a United States citizen, who files his returns on a calendar year basis, is privately employed and a bona fide resident of Italy for the period January 1, 1961, through December 31, 1963. He is compensated at a rate of $25,000 per year and receives such compensation in the year it is earned. The amounts excludable from gross income for the various calendar years and the applicable provisions of section 911 of the code are as follows: for the years 1961 and 1962, $25,000 under section 911 before amendment by section 12 of the bill; for the year 1963, $20,000 under section 911, as amended by the bill.

Example (2).—A, the taxpayer described in example (1), receives on May 1, 1963, $5,000 as a supplementary salary payment for services performed during the taxable year 1962. Such amount is received pursuant to an agreement in existence on March 12, 1962. Under section 12(c)(2)(B) of the bill, such amount will be subject to section 911 of the code before amendment. The entire supplementary salary payment will be excludable from gross income under section 911(a)(1) (before amendment).

Example (3).—The facts are the same as in example (2), except that no right to receive the $5,000 supplementary salary payment is in existence on March 12, 1962. Under section 12(c)(2)(B) of the bill, such amount is to be subject to the provisions of section 911, as amended by the bill. Under section 911, as amended, the amount excludable is to be computed under section 911(c). Under section 911(c)(2), the supplementary salary payment is to be considered received in 1962. Under section 911(c)(1), that portion of the amount received which, when added to other qualifying amounts received during the taxable year 1962, does not exceed an amount computed on a daily basis at an annual rate of $20,000 will be excludable. Since, under the facts set forth in example (1), A received excludable amounts in excess of $20,000 during the taxable year 1962, no part of the supplementary salary payment is to be excludable from gross income.

SECTION 13. CONTROLLED FOREIGN CORPORATIONS

(*a*) *Tax on United States shareholders*.—Subsection (a) of section 13 of the bill adds a new subpart F to part III of subchapter N of the Internal Revenue Code of 1954. The new subpart consists of eight sections (secs. 951–958).

SECTION 951. AMOUNTS INCLUDED IN GROSS INCOME OF UNITED STATES PERSONS

(*a*) *Amounts included*.—Subsection (a) provides that, if a foreign corporation is a controlled foreign corporation on any day of its taxable year, then any United States person who owns stock (within the meaning of section 955(a)) in such corporation, on the last day of such taxable year on which it was a controlled foreign corporation,

must include in gross income for his taxable year (in which or with which ends the taxable year of the controlled foreign corporation) a pro rata share of the corporation's subpart F income and a pro rata share of that portion of the increase in its earnings invested in nonqualified property which is not excluded from gross income under section 956(a). Such shares are included in the income of the United States person, even though there may be intervening entities in a chain between the controlled foreign corporation and such person.

The pro rata share to be included by the United States person (if the corporation is a controlled foreign corporation for its entire taxable year) is that amount which would have been distributed with respect to the ownership interest of such person if the corporation had distributed the total amount of its subpart F income and the total amount of such portion of the increase in its earnings invested in nonqualified property on the last day of its taxable year. If the corporation is a controlled foreign corporation for only part of its taxable year, paragraphs (2) and (3) provide that the pro rata share is that which would have been distributed (on the last day of the corporation's taxable year on which it was a controlled foreign corporation) if the controlled foreign corporation had distributed pro rata an amount which bears to such total amount the same ratio that the part of the year during which the corporation was a controlled foreign corporation bears to the entire taxable year.

Example (1).—X, a United States person, wholly owns throughout 1963 Y, a controlled foreign corporation, which has $100 of subpart F income and $100 of earnings and profits for its taxable year 1963. Both X and Y use a calendar year as their taxable year. X, for taxable year 1963, must include $100 in gross income as if such amount had been distributed on December 31, 1963.

Example (2).—X and T, United States persons with the calendar year as a taxable year, each acquire on July 1, 1963, 30 percent of the voting stock of Y, a foreign corporation (having only one class of stock) which became, as of that day, a controlled foreign corporation. Y has no subpart F income for its taxable year (also the calendar year), has $100 of earnings and profits for such year, and has a $100 increase in earnings invested in nonqualified property for its 1963 taxable year. For their 1963 taxable year, X and T each must include in gross income $15, the amount which would have been distributed with respect to their stock if Y had distributed pro rata ½ of $100, or $50 on December 31, 1963.

Subpart F income may not exceed the earnings and profits for the taxable year (computed without reduction for distributions made during that year). The increase in investment in nonqualified property, however, is limited to the sum of the earnings and profits for the taxable year (computed without reduction for distributions made during that year) plus the earnings and profits accumulated for prior taxable years beginning after December 31, 1962. Thus, in examples (1) and (2) it would be irrelevant for purposes of section 951(a) whether Y made an actual distribution during 1963. Such distribution would not, however, because of the rules in section 956, result in further tax to X (in example (1)) or X and T (in example (2)).

An increase in earnings invested in nonqualified property is included in gross income only to the extent that it exceeds the subpart F income for the current taxable year and previous taxable years, but only if

such subpart F income has not already been so used as an offset or has not been actually distributed in a previous taxable year. Distributions from amounts taxed under section 951(a)(1) as increases in earnings invested in nonqualified property and subpart F income are excluded from gross income under section 956. Rules for allocation of distributions to subpart F income, increased earnings invested in nonqualified property, or other earnings and profits are made under the rules of section 956(c).

In a case in which stock of a controlled foreign corporation is transferred by one United States person to another during a taxable year, if the transferor United States person receives a dividend with respect to such stock, the acquiring shareholder, under section 951(a)(2)(B), may reduce the amount he would otherwise be required to include in gross income under section 951(a)(1)(A) by the amount of such dividend. For example, assume that X owns 20 percent of the one class of stock in Z, a controlled foreign corporation, and that on July 1, 1963, immediately after receiving a $10 dividend, X transfers the stock to Y. X, Y, and Z use the calendar year as the taxable year. Z's entire earnings and profits for 1963 consists of $100 all of which is subpart F income. X must include in gross income the $10 dividend. Y must include $10 ($20 minus $10) in his gross income for 1963.

(*b*) *Less than 10 percent ownership.*—Subsection (b) limits United States persons subject to tax under subsection (a) to those who own at least 10 percent of the total combined voting power of all classes of stock, or the total value of shares of all classes of stock, of the controlled foreign corporation. The rules of constructive ownership of section 955(b) are applicable for this purpose, although the rules of constructive ownership of section 955(a) are applicable to determine such person's liability under section 951(a).

Example.—H owns 5 percent of the one class of stock of X, a controlled foreign corporation, and his wife, W, owns 10 percent of the stock of such corporation. Under the rules of section 955(b), H is considered to own 15 percent of the stock of X and will be subject to tax on the income attributable to his 5 percent interest.

(*c*) *Coordination with election of a foreign investment company to distribute income.*—Subsection (c) provides that a United States person who, for his taxable year, is a qualified shareholder, within the meaning of section 1247(c), of a foreign investment company with respect to which an election under section 1247 is in effect is not required to include in gross income for such year the subpart F income of such company.

SECTION 952. SUBPART F INCOME DEFINED

Section 952 defines the three types of income of a controlled foreign corporation which constitute "subpart F income" and may be includible in the gross income of United States persons, as defined in section 7701(a)(30), under the provisions of section 951(a)(1)(A).

(*a*) *In general.*—Paragraph (1) of section 952(a) provides that the subpart F income of a controlled foreign corporation, for purposes of section 951(a)(1)(A), is the sum of (1) the income of the controlled foreign corporation derived from insurance of United States risks, as determined under subsection (b); (2) the income of the controlled

foreign corporation from United States patents, copyrights, and exclusive formulas and processes, as determined under subsection (c); and (3) the net foreign base company income of a controlled foreign corporation as determined under subsection (d). Net foreign base company income of a controlled foreign corporation, however, is included in subpart F income only if five or fewer United States persons own, directly or indirectly, within the meaning of section 955(b), more than 50 percent of the total combined voting power of all classes of stock entitled to vote.

Paragraph (2) provides for the exclusion from subpart F income of a controlled foreign corporation of amounts included in gross income of the controlled foreign corporation under chapter 1 of the code where the controlled foreign corporation is engaged in trade or business in the United States and such income is treated as income from sources within the United States.

Paragraph (3) provides that the subpart F income of a controlled foreign corporation for any taxable year of such corporation may not exceed the earnings and profits of the controlled foreign corporation for that year (computed without reduction for distributions made during the year).

(*b*) *Income from insurance of United States risks.*—Paragraph (1) of subsection (b) provides, in general, that income derived from the insurance of United States risks is that income which would be taxed under subchapter L of chapter 1 if the controlled foreign corporation were a domestic corporation. However, such income is included in subpart F income only if, in respect of reinsurance or the issuing of insurance or annuity contracts, premiums or other consideration are received either (A) on risks in connection with property in, or residents of, the United States or (B) on risks in connection with property not in, or nonresidents of, the United States in accordance with any arrangement that a substantially equal amount of premiums or other consideration in respect of reinsurance or the issuing of insurance or annuity contracts on risks in connection with property in, or residents of, the United States is to be received by another corporation.

Paragraph (2) of subsection (b) provides special rules which modify the application of subchapter L for purposes of this subsection.

Under subparagraph (A) of paragraph (2), respecting the application of part I of subchapter L, life insurance company taxable income is defined solely as the gain from operations under section 809(b) despite the provisions of section 802(b).

Under subparagraph (B) of paragraph (2), the taxable income of all insurance companies other than life insurance companies, that is, both mutual and stock insurance companies which are ordinarily subject to the provisions of part II or part III of subchapter L, respectively, is to be determined under part III of subchapter L.

Subparagraph (C) of paragraph (2) disallows certain deductions from income for purposes of this subsection. These deductions are:

(i) Section 809(d)(4) (operations loss deduction),

(ii) Section 809(d)(5) (certain nonparticipating contracts),

(iii) Section 809(d)(6) (group life, accident, and health insurance),

(iv) Section 809(d)(10) (small business deduction),

(v) Section 817(b) (gain on property held on December 31, 1958, and certain substituted property acquired after 1958), and

(vi) Section 832(b)(5) (certain capital losses).

Under subparagraph (D) of paragraph (2), "gross amount" to the extent prescribed in section 809(c) (1) and (2), less the "increases in certain reserves" as defined in section 809(d)(2), and "premiums earned" as defined in section 832(b)(4), are taken into account only to the extent connected with the United States risks described in section 952(b)(1)

Under subparagraph (E) of section 952(b)(2), all other items of income, that is items other than those taken into account under subparagraph (D), as well as all items of expenses, losses, and deductions shall be apportioned under regulations prescribed by the Secretary of the Treasury or his delegate.

(c) *Income from United States patents, copyrights, and exclusive formulas and processes.*—Paragraph (1) defines the term "income from United States patents, copyrights, and exclusive formulas and processes" as used in section 952(a)(1)(B). Such term means the amount of gross rentals, royalties, or other income derived from the license, sublicense, sale, exchange, use, or other means of exploitation of patents, copyrights, and exclusive formulas and processes which are—

(1) either substantially developed, created, or produced in the United States, or

(2) acquired from (A) a United States person which, directly or indirectly, owns or controls the controlled foreign corporation, (B) a United States person owned or controlled, directly or indirectly, by the controlled foreign corporation, or (C) a United States person which is, directly or indirectly, under common ownership or control with the controlled foreign corporation.

The amount described in the preceding sentence is reduced by the cost and expense allowance defined in section 952(c)(2). Under this definition, if a domestic corporation develops in the United States an exclusive process to be used in the production of a certain product, and a right (whether exclusive or nonexclusive) to use this process is granted to a controlled foreign corporation, the income derived from the use of such process by such controlled foreign corporation would be treated as income derived from a United States exclusive process.

Paragraph (2) permits a controlled foreign corporation to deduct an allowance, in accordance with regulations prescribed by the Secretary of the Treasury or his delegate, for ordinary and necessary expenses incurred by the controlled foreign corporation in the receipt or production of the gross income described in paragraph (1) (including gross income the amount of which is determined under paragraph (3)). The allowance so made includes taxes paid by the controlled foreign corporation with respect to such gross income and an amount necessary to amortize or depreciate the cost to the controlled foreign corporation of the property or rights described in paragraph (1). Thus, if a controlled foreign corporation purchased from a United States person a right developed in the United States for the sum of $100,000, and if the right was for a period of four years, the controlled foreign corporation would for this purpose be allowed to amortize the $100,000 cost over the four-year period and deduct such amount from gross income derived from the use of such right.

Paragraph (3) establishes the rule for determining gross rent, royalty, or other income, for purposes of section 952(c), if the controlled foreign corporation uses or exploits a United States patent,

copyright, or exclusive formula or process other than by license, sub-license, sale, or exchange. In such cases, the gross rent, royalty, or other payment is considered to be the amount the controlled foreign corporation would have been required to pay if the property or right had been obtained in an arm's length transaction with an unrelated person. For example, if a controlled foreign corporation received, without cost, from its United States parent a right to use a patent in its operation, section 952(c) requires that a gross royalty be determined. The gross amount so determined by applying the standards of an arm's length transaction, reduced by paragraph (2) expenses, is included in subpart F income.

(*d*) *Net foreign base company income.*—Subsection (d) defines the term "net foreign base company income" as used in section 952(a)(1)(C). The term is defined to mean (1) the foreign base company income for the taxable year, reduced by (2) the increase in investment in qualified property in less developed countries for the taxable year.

(*e*) *Foreign base company income.*—Paragraph (1) of subsection (e) defines the term "foreign base company income" as used in section 952(d). The term is defined to mean foreign personal holding company income (as defined in section 553) for the taxable year, with the modifications and adjustments provided in paragraphs (2) through (7) of section 952(e).

Paragraph (2) of section 952(e) provides that foreign base company income includes "foreign base company sales income", if, for the taxable year, such sales income is equal to at least 20 percent of the gross income of the foreign corporation, not including for this purpose other foreign base company income under section 952(e). The term "foreign base company sales income" is defined to mean income (whether in the form of profits, commissions, fees, or otherwise) derived in connection with the purchase of personal property from a related person and its sale to any person, or the purchase of personal property from any person and its sale to a related person. Such property purchased, however, must have been (A) manufactured, produced, grown, or extracted outside the country under the laws of which the controlled foreign corporation is created or organized, and (B) sold for use, consumption, or disposition outside such foreign country. Thus, the income from the purchase and sale of personal property does not constitute foreign base company sales income if the property purchased is resold for use in the country in which the controlled foreign corporation is created, or the property purchased is an agricultural product, mineral, or manufacture, of the country in which the controlled foreign corporation is created.

Since the definition covers only transactions involving both a purchase and a sale, it does not apply to income of a controlled foreign corporation from the sale of a product which it manufactures. In a case in which a controlled foreign corporation purchases parts or materials which it then transforms or incorporates into a final product, income from the sale of the final product would not be foreign base company sales income if the corporation substantially transforms the parts or materials, so that, in effect, the final product is not the property purchased. Manufacturing and construction activities (and production, processing, or assembling activities which are substantial in

nature) would generally involve substantial transformation of purchased parts or materials.

Commissions received for furnishing services in connection with sales transactions discussed above would also be included in foreign base company sales income.

Since the definition of foreign base company sales income also depends on whether property is sold for use, consumption, or disposition outside the country under the laws of which the controlled foreign corporation is created or organized, a destination test applies. Generally property will be considered to be used, consumed, or disposed of in the country to which it is delivered unless circumstances indicate that the property is to be exported after it is so delivered.

For determining whether a controlled foreign corporation purchases from, or sells to, a related person, a person is a related person as to the controlled foreign corporation if he, directly or indirectly, owns or controls, or is owned or controlled by, or is under common ownership or control with, the controlled foreign corporation.

Paragraph (3) of section 952(e) provides that foreign base company income includes all rents whether or not such rents constitute more than 50 percent of gross income. Section 553 already achieves such a result as to royalties.

Paragraph (4) of section 952(e) provides that foreign base company income does not include income derived from insurance of United States risks (provided for under subsection (b)), or from United States patents, copyrights and exclusive formulas and processes (provided for under subsection (c)).

Paragraph (5) of section 952(e) provides that foreign base company income does not include income of a corporation described in section 552(b), which excepts banks and exempt corporations from the foreign personal holding company provisions, nor does it include income of a foreign corporation 50 percent or more of the fair market value of whose outstanding stock is owned directly or indirectly by a domestic corporation which is either organized under section 25(a) of the Federal Reserve Act, or which has an agreement or an understanding with the Board of Governors of the Federal Reserve System under section 25 of such Act, if all the stock (except qualifying shares) of the domestic corporation is owned by a national or state bank which is a member of the Federal Reserve System.

Paragraph (6) of section 952(e) provides that, if the foreign base company income (before deductions) for the taxable year is less than 20 percent of gross income, no part of the income is to be treated as foreign base company income, but, if foreign base company income (before deductions) for the taxable year exceeds 80 percent of gross income, the entire gross income is to be taken into account in determining foreign base company income.

Paragraph (7) of section 952(e) provides that the foreign base company income for the taxable year shall be reduced so as to take into account deductions (including taxes) properly allocable to such income.

(*f*) *Investment in qualified property in less developed countries.*—Paragraph (1) of subsection (f) provides the rule for determining the increase in investment in qualified property in less developed countries (this is the amount by which foreign base company income is reduced under subsection (d) to obtain net foreign base company income).

This increase is the amount by which the aggregate amount of certain property held at the close of the taxable year exceeds the aggregate amount of such property held at the close of the preceding taxable year. The property taken into account for this purpose is—

(A) qualified property described in sections 953(b)(2)(C) and (D), and

(B) property (including money) which is located outside the United States and is ordinary and necessary for the active conduct for a qualified trade or business described in section 953(b)(3)(A)(ii).

Paragraph (2) of subsection (f) provides that, under regulations prescribed by the Secretary of the Treasury or his delegate, a controlled foreign corporation may elect to determine the aggregate amount of the property described in paragraph (1) held at the close of the taxable year and at the close of the preceding taxable year as of the close of the 75th day after the close of each taxable year.

Paragraph (3) of subsection (f) provides that the amount taken into account under subsection (f)(1) with respect to any property is to be its adjusted basis, reduced by any liability to which the property is subject.

SECTION 953. INVESTMENT OF EARNINGS IN NONQUALIFIED PROPERTY

Section 953 establishes rules for determining the extent to which a controlled foreign corporation's increase in earnings is invested in nonqualified property and thus includible, under the provisions of section 951(a)(1)(B), pro rata in gross income of United States persons. Subsection (a) establishes rules for determining a United States persons pro rata share of a controlled foreign corporation's "increase in earnings invested in nonqualified property". Subsection (b) defines the term "nonqualified property".

(*a*) *General rules.*—Paragraph (1) of section 953(a) provides that the amount of earnings of a controlled foreign corporation invested in nonqualified property at the end of any taxable year is the aggregate amount of such property held at the close of the taxable year, but not in excess of the sum of the earnings and profits for the taxable year and the earnings and profits accumulated for prior taxable years beginning after December 31, 1962.

Paragraph (2) of section 953(a) provides that the increase for any taxable year of a United States person's pro rata share of the earnings of a controlled foreign corporation invested in nonqualified property is the amount determined by subtracting, from his pro rata share of the amount determined under paragraph (1) for the close of the taxable year, his pro rata share of the amount determined under paragraph (1) for the close of the preceding taxable year, reduced by amounts paid during the taxable year to which section 956(c)(1) applies.

Paragraph (3) of section 953(a) provides that the amount taken into account under paragraphs (1) or (2) with respect to any property is to be its adjusted basis, reduced by any liability to which the property is subject.

(*b*) *Nonqualified property defined.*—Paragraph (1) of subsection 953(b) provides the general rule that the term "nonqualified property"

means any money or other property, tangible or intangible, which is not "qualified property" (as defined in paragraph (2) of section 953(b)). However, all property acquired by a controlled foreign corporation before January 1, 1963, is treated as if it were qualified property, whether or not it comes within the definition of paragraph (2).

Paragraph (2) of section 953(b) defines the term "qualified property". Thus, any property of a controlled foreign corporation which does not qualify under one of the four categories listed in paragraph (2), with the exception of property acquired before January 1, 1963, is considered to be nonqualified property for purposes of the new subpart F.

Subparagraph (A) of section 953(b)(2) includes within the definition of "qualified property" money or other property which is ordinary and necessary for the active conduct of a "qualified trade or business" of the controlled foreign corporation, provided the money or other property is located outside the United States.

Subparagraph (B) of section 953(b)(2) provides that property which would qualify under subparagraph (A) except for the fact that it is located in the United States is still to be treated as qualified property if it is referred to in clause (i), (ii), or (iii) of subparagraph (B). Clause (i) refers to obligations of the United States, money, or deposits with persons carrying on the banking business. Clause (ii) refers to property purchased in the United States for export to, or for use in, foreign countries. Clause (iii) refers to any loan arising in connection with the sale of property, if the amount of such loan outstanding at no time during the taxable year exceeds the amount which would be ordinary and necessary to carry on the trade or business of both the lending corporation and the borrowing United States person had the sale been made between unrelated persons.

Subparagraph (C) of new section 953(b)(2) defines "qualified property" to include certain stock investments in certain foreign corporations. Under this provision, stock owned by a controlled foreign corporation is considered qualified property if the criteria set forth in subparagraph (C) are satisfied. First, the foreign corporation whose stock is owned must be created or organized under the laws of a less developed country, as defined in section 953(b)(5). Second, such foreign corporation must be engaged in the active conduct of a trade or business in the country in which it was created or organized. Third, substantially all of the property of such foreign corporation must be ordinary and necessary for the active conduct of its trade or business, and such business must be engaged in almost wholly within less developed countries. Fourth, more than 50 percent of the total combined voting power of all classes of stock entitled to vote must be owned, directly or indirectly, by the controlled foreign corporation and four or fewer United States persons; except that if the laws under which such foreign corporation is created or organized limit the amount of voting stock which is permitted to be owned, such lesser percentage of ownership as is permitted must be owned, directly or indirectly, by the controlled foreign corporation and four or fewer United States persons. Fifth, the controlled foreign corporation must own at least 10 percent of the voting stock and 10 percent of the value of all classes of stock of such foreign corporation.

Subparagraph (D) of section 953(b)(2) includes within the definition of "qualified property" investments required because of restrictions imposed by the laws of a less developed country, as defined in section 953(b)(5). In addition, investments made at a time when restrictions imposed by the laws of a less developed country required that the investment be made may be held as qualified property, even though such restrictions have been removed, if withdrawal of the investment would result in substantial losses to the controlled foreign corporation.

Paragraph (3) of subsection 953(b) defines the term "qualified trade or business," used in section 953(b)(2)(A). As defined, a trade or business of a controlled foreign corporation is a qualified trade or business if such trade or business, or substantially the same trade or business, is carried on by the controlled foreign corporation outside the United States and has been so carried on by such corporation, while controlled by substantially the same United States persons either (1) since December 31, 1962, or (2) during the 5-year period ending with the close of the preceding taxable year of the controlled foreign corporation. In determining whether or not a trade or business is the same or substantially the same trade or business during the applicable period, all the facts and circumstances of the particular case must be taken into consideration. The test is intended to prevent the use of earnings which have not been subjected to U.S. tax to diversify the business of the controlled foreign corporation, while permitting the controlled foreign corporation to compete in the lines of activity it is presently engaged in. In this regard, circumstances which may be particularly important involve the nature of the product line of the controlled foreign corporation and the character of the principal foreign competitors of the controlled foreign corporation in that line.

In addition, a trade or business carried on by a controlled foreign corporation will constitute a qualified trade or business if it is carried on almost wholly within a less developed country.

For purposes of paragraph (3), even where there have been changes in the ownership of U.S. persons, a controlled foreign corporation may be considered controlled by substantially the same United States persons if more than 50 percent of the voting power of all classes of stock entitled to vote was owned, directly or indirectly, by either the same United States persons or other United States persons whose relationship indicates that there has been no substantial change in interest. For example, stock transferred to the estate or heirs of a deceased owner by reason of his death, or stock transferred by a domestic corporation to a 100-percent-owned domestic subsidiary, may be considered for purposes of subparagraph (3) to have been held by substantially the same United States persons.

Subparagraph (B) of section 953(b)(3) treats an investment of a controlled foreign corporation as having been made in a qualified trade or business of the controlled foreign corporation if the amount of the investment is made in the stock of a second foreign corporation in which the controlled foreign corporation has owned at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total value of all classes of stock continuously since December 31, 1962, or if the controlled foreign corporation owned such amount of stock continuously during

the entire 5-year period ending with the close of the controlled foreign corporation's preceding taxable year. In this situation the second controlled foreign corporation receiving the amount invested by the first controlled foreign corporation must use the amount received in the conduct of a trade or business which would qualify under subparagraph (A) as if it were conducted by the first controlled foreign corporation.

Paragraph (4) of section 953(b) provides that obligations of United States persons held by controlled foreign corporations are considered property located in the United States, as are pledges or guarantees made with respect to obligations of United States persons.

Paragraph (5) of section 953(b) defines the term "less developed country." Except for certain countries and areas specified in the paragraph which may not be designated as less developed countries, the designation of which countries are less developed is left to Executive order.

SECTION 954. CONTROLLED FOREIGN CORPORATIONS

(*a*) *Controlled foreign corporations defined.*—Subsection (a) defines "controlled foreign corporations," for purposes of the new subpart F, to mean a foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned by United States persons on any day during the taxable year of the corporation. In this connection, constructive rules of ownership provided in section 955(b) apply.

(*b*) *Special rule for insurance.*—Subsection (b) provides a special definition of controlled foreign corporations solely for the purpose of including the income derived from insurance of United States risks, referred to in section 952(a)(1)(A), in the gross income of a United States person. Under the special definition "controlled foreign corporation" includes not only a foreign corporation satisfying subsection (a) but also one of which more than 25 percent of the total combined voting power of all classes of stock is owned by United States persons, on any day during the taxable year of a corporation, if the gross amount of premiums or other consideration in respect of any reinsurance or issuing of insurance or annuity contracts in connection with property in the United States, or residents of the United States, exceeds 75 percent of the gross amount of all premiums or other consideration in respect of all risks. Only the subpart F income consisting of income from insurance of United States risks is required to be included in the gross income of a United States person owning stock in a corporation satisfying subsection (b) but not subsection (a).

(*c*) *Special rule for certain less developed countries.*—Subsection (c) also provides a special definition for those controlled foreign corporations, created or organized under the laws of a less developed country, stock in which is "qualified property" under section 953(b)(2)(C). The special rule provides that the maximum percentage of ownership (if 50 percent or less) permitted under the laws of a less developed country is considered, in lieu of the more than 50 percent requirement in subsection (a), the percentage required under subsection (a) in order for the corporation to be classified as a controlled foreign corporation.

SECTION 955. RULES FOR DETERMINING STOCK OWNERSHIP

Section 955 provides, in subsection (a), a limited rule of stock ownership for determining the amount taxable to a United States person, and, in subsection (b), a broader set of constructive rules of ownership for determining whether the requisite ownership by United States persons exists so as to make a corporation a controlled foreign corporation or a United States person has the requisite ownership to be liable for tax under section 951(a).

(*a*) *For purposes of section 951*(*a*).—Subsection (a) provides that for purposes of determining the amount of the income of a corporation which is taxable to a United States person under section 951(a), a United States person owns the stock which he owns directly in a foreign corporation and also that which he owns through certain foreign entities as follows: stock owned, directly or indirectly, by or for a foreign corporation, foreign partnership, or a foreign trust or foreign estate (within the meaning of section 7701(a)(31)) is considered as proportionately owned by the shareholders, partners, or beneficiaries. Stock owned by such a foreign entity with the application of such rule is considered as actually owned by such foreign entity for again applying the rule. The rule in effect gives rise to a chain of ownership and, since the rule operates only on stock owned by a foreign entity, attribution under the rule stops with the first United States person in the chain of ownership running from the controlled foreign corporation to such person. For example, W, a domestic corporation, owns 80 percent of the class of stock of X, a foreign corporation, which in turn owns 80 percent of the class of stock of Y, another foreign corporation, which in turn owns 90 percent of the only class of stock in Z. Under the rule, X is considered as owning 80 percent of the 90 percent which Y owns in Z, or 72 percent. 80 percent of such 72 percent, or 57.6 percent of the stock in Z, is considered as owned by W. Since W is a domestic corporation which is a United States person, W is the person taxed even though W is wholly owned by U, another domestic corporation. If Z has $100 of subpart F income, then W is required to include $57.60 in gross income under section 951(a).

Paragraph (3) of subsection (a) provides, for the sole purpose of taxing United States persons on a foreign mutual insurance company's income derived from insurance of United States risks, that the term "stock" includes any certificate entitling the holder to voting power in the corporation.

(*b*) *Other provisions.*—Subsection (b) provides constructive rules of ownership based, with certain specified exceptions, on section 318. The principle to be followed in applying such rules is that they are to be applied so that the effect is to subject a United States person to the requirement of section 951(a), to treat 5 or fewer U.S. persons as owning more than 50 percent of all classes of stock entitled to vote for purposes of requiring a controlled foreign corporation to include net foreign base company income in its subpart F income, or to make a corporation a controlled foreign corporation under section 954.

The specified exceptions to the rules of section 318 are as follows:

(1) No attribution of ownership from a nonresident alien individual (other than a foreign estate or trust) to a citizen or

resident of the United States can occur under section 318(a)(1)(A);

(2) In considering stock owned by a partnership, estate, trust, or corporation, as owned by the partners, beneficiaries, or shareholders—

(A) a partnership, estate, trust, or corporation which owns more than 50 percent of the total combined voting power of all classes of stock entitled to vote, is to be considered as owning all the voting power of all such classes of stock;

(B) a partnership, estate, trust, or corporation which owns more than 50 percent of the total value of shares of all classes of stock of a corporation is to be considered as owning the total value of all classes of stock;

(3) Stock of a partner, beneficiary, or shareholder which is attributed to the partnership, estate, trust, or corporation will not be attributed out to another partner, beneficiary, or shareholder; and

(4) The requirement that a corporate shareholder own more than 50 percent of the stock of a corporation before ownership of such stock can be attributed to the shareholders of such corporate shareholder is not to apply.

Example (1).—M, N, and O, all United States persons, each own 20 percent of the stock in X, a foreign corporation having only one class of stock, which in turn owns 60 percent of the stock in Y, also a foreign corporation having only one class of stock. For the purpose of attributing the stock owned by X in Y to M, N, and O, X is considered as owning all of the stock of Y with the result that M, N, and O are considered as each owning 20 percent of the stock of Y.

Example (2).—X, an owner of 50 percent of the one class of stock in Y, owns 8 percent of the one class of stock in Z, a controlled foreign corporation; W, the owner of the other 50 percent of the stock in Y owns 45 percent of the one class of stock of Z. X is considered as owning no part of the stock in Z which is owned by W. Thus, X does not own 10 percent or more of the stock of Z so as to be required under section 951(a) to include in gross income any amount of income of Z.

SECTION 956. EXCLUSION FROM GROSS INCOME OF PREVIOUSLY TAXED EARNINGS AND PROFITS

(*a*) *Exclusion from gross income of United States persons.*—Subsection (a) provides that earnings and profits of a foreign corporation attributable to amounts once included in gross income under section 951(a) are not again included in gross income when actually distributed. The exclusion is applicable whether the income included in gross income under section 951 was required to be included by reason of direct ownership of stock in a controlled foreign corporation or ownership through a chain of ownership described in section 955(a). Further, the exclusion applies with respect to the United States person who owned stock in a foreign corporation at the time it was included in gross income under section 951(a), or with respect to a successor in interest who can at the time of the actual distribution provide such proof as the Secretary of the Treasury or his delegate by regulations require that he holds the interest of the United States person who

previously included in gross income the earnings and profits being distributed.

Example.—On December 31, 1963, X, a United States person, owns 20 shares of the 100 shares of the only class of stock in Z, a controlled foreign corporation, and by reason of such ownership includes $20 in gross income under section 951 (his proportionate share of Z's $100 of subpart F income which constituted Z's entire earnings and profits for its 1963 taxable year). On January 31, 1964, X transfers 9 shares of his stock in Z to Y. On June 1, 1964, X receives an $11, and Y a $9, distribution from Z. Neither the $11 received by X nor the $9 received by Y is includible in gross income.

Subsection (a) in conjunction with section 951(a)(1)(B) also prevents including in gross income under section 951(a)(1)(B) any increase in earnings invested in nonqualified property to the extent such increase can be considered as attributable to subpart F income taxable under section 951(a)(1)(A). Subpart F income thus provides an offset to prevent the inclusion in gross income of amounts otherwise includible as an increase in earnings invested in nonqualified property. For example, Z, a controlled foreign corporation wholly owned by X, a domestic corporation, has $40 subpart F income, and a $50 increase in earnings invested in nonqualified property; X includes in gross income only $10 of the $50 because $40 of such $50 is offset by the $40 of subpart F income included in X's gross income.

(*b*) *Exclusion from gross income of certain foreign subsidiaries.*—Subsection (b) provides that, for purposes of section 951(a), income of a controlled foreign corporation once included in gross income of a United States person is not, when distributed to another controlled foreign corporation, included in any of such other foreign corporation's income which must be taxed to such United States person or his successor in interest. For example, X, a domestic corporation, wholly owns Y, a controlled foreign corporation which in turn wholly owns Z, another controlled foreign corporation. In 1970, Y has no income except that which is received from Z, which has $100 of income which X is required to include in gross income under section 951. Such $100, although paid to Y as a dividend in 1970, is not included in the income of Y which must be included in the gross income of X, even though such a dividend would ordinarily constitute subpart F income. The same result follows whether the dividend is paid in 1970 or a later year so long as under the rules of subsection (c) it is allocated to earnings and profits under paragraphs (1) and (2) which were once included in X's gross income under section 951.

(*c*) *Allocation of distributions.*—Subsection (c) provides rules for the allocation of distributions to earnings and profits. Amounts included in gross income of a shareholder under section 951(a) do not constitute distributions for purposes of reducing the earnings and profits of the controlled foreign corporation. Accordingly, when the controlled foreign corporation makes an actual distribution, thereby reducing its earnings and profits, it is necessary at the shareholder level to identify whether the distribution is from earnings and profits attributable to amounts already included in gross income of the shareholder under section 951(a) (in which case the distribution is not taxable as a dividend) or is from earnings and profits which are attributable to amounts not so taxed (in which case the distribution is taxable as a dividend). Under subsection (c), earnings and profits

attributable to amounts once taxed (described in paragraphs (1) and (2)) are to be considered to be distributed until they are exhausted (first from the current year and next from past years). Subsequent distributions, after the earnings and profits described in paragraphs (1) and (2) have been received by a shareholder, are taxable as dividends to the extent of the remaining earnings and profits.

A shareholder is not taxable on a distribution which is out of earnings and profits described in paragraph (1) (relating to earnings invested in nonqualified property) or paragraph (2) (relating to subpart F income). The separate classification of earnings and profits under paragraphs (1) and (2) is for purposes of computing a United States person's pro rata share of the increase in earnings in nonqualified property under section 953. For purposes of section 953(a)(2)(A), the amount of earnings invested in nonqualified property for a taxable year is reduced by earnings so invested which were actually distributed. For this purpose, paragraph (1) of section 956(c) provides that earnings and profits attributable to investment in nonqualified property are the first earnings and profits considered as distributed to a shareholder.

In this connection, although amounts taxed once under section 951 (a)(1)(A) as subpart F income may offset amounts representing an increase in earnings in nonqualified property under section 951 (a)(1)(B) (so as to avoid taxing the same earnings twice) such offset does not affect the amount of earnings and profits attributable to amounts representing the increase in earnings in nonqualified property for purposes of paragraph (1). The amount of earnings and profits under paragraph (1) includes earnings and profits attributable to amounts includible in gross income under section 951(a)(1)(B) as well as earnings and profits attributable to amounts which would have been included under such section except for the availability of the offset by reason of the inclusion of amounts under section 951(a)(1)(A) as subpart F income. Earnings and profits attributable to amounts included in subpart F income, but used to offset an increase in earnings invested in nonqualified property are not, however, included in paragraph (2) since they are already included in paragraph (1). Thus, there is no duplication in the amounts attributable to paragraphs (1) and (2), and, from the standpoint of the shareholder, the amount of earnings and profits allocable to him under paragraphs (1) and (2) is always equal to the amount of income he has been taxable on under section 951(a) (and for which he has not received an actual distribution).

(*d*) *Distributions excluded from gross income not to be treated as dividends.*—Except for deeming foreign taxes paid by foreign corporations as being paid by a domestic corporation in special cases discussed below, a distribution excluded from gross income under section 956 is treated as a distribution which is not a dividend.

SECTION 957. SPECIAL RULES FOR FOREIGN TAX CREDIT

A domestic corporation owning stock in a controlled foreign corporation is required to include in its gross income, under the provisions of subpart F, income of such foreign corporation, whether or not the foreign corporation is one or more links removed in a chain of ownership. Therefore, section 902 (relating to credit for corporate stock-

holder in foreign corporation) which depends on actual distributions would not operate to give the domestic corporation a credit for foreign taxes paid by the controlled foreign corporation. Section 957 provides rules, consistent with section 902, for treating foreign taxes paid by controlled foreign corporations on income which is included in the gross income of domestic corporations under section 951(a) as having been paid by such domestic corporations.

(*a*) *Taxes paid by a foreign corporation.*—Subsection (a) applies to a domestic corporation which includes in gross income under section 951(a) an amount attributable to earnings and profits of a foreign corporation at least 10 percent of the voting stock of which is directly owned by such domestic corporation, or of a foreign corporation at least 50 percent of the voting stock of which is owned by a foreign corporation at least 10 percent of the voting stock of which in turn is directly owned by the domestic corporation. Such a domestic corporation is deemed to have paid the same proportion of the total income, war profits, and excess profits taxes paid by the controlled foreign corporation to a foreign country or possession of the United States for its taxable year which the amount of the earnings and profits of the foreign corporation included in gross income of the domestic corporation bears to the entire earnings and profits of such foreign corporation for such taxable year.

Example (1).—X, a domestic corporation, wholly owns Y, a foreign corporation, which in turn wholly owns Z, another foreign corporation. X, Y, and Z each use the calendar year as a taxable year. For 1963, X is deemed to have paid taxes actually paid by Y and Z as follows:

	X	Y	Z
Earnings and profits		60	80
Foreign taxes		40	20
Subpart F income		30	50
Gross income under sec. 951 (30+50)	80.00		
Foreign taxes deemed paid by X under sec. 957(a) and included in gross income under sec. 78:			
$\left(\frac{30}{60} \times 40\right)$	20.00		
$\left(\frac{50}{80} \times 20\right)$	12.50		

If a domestic corporation receives a distribution any part of which is excluded from gross income under section 956, the foreign taxes which are deemed to have been paid under section 957(a) are not again deemed paid under section 902. Other foreign taxes which are not deemed paid under section 957 because paid, for instance, by a first-tier corporation, through which profits of a second-tier corporation are distributed (after having been taxed under section 951 to a United States corporation), will still be deemed paid under section 902 when an actual distribution is made. A distribution of such profits, although excluded under section 956(a), is treated by the domestic corporation as a dividend solely for taking into account under section 902 such foreign taxes as were not deemed paid under section 957.

Example (2).—Suppose that the $50 of subpart F income of Z taxed to X in 1963 in the example above was in 1970 distributed to Y who received no other income for such year, and that Y paid a tax of $20 for 1970 and distributed the remaining $30 to X before the end of 1970.

In such case, although such $30 is excluded from gross income under section 956(a), it is treated as a dividend under section 902 so that for 1970, X is deemed to have paid $20 in foreign taxes.

Under paragraph (4) of section 957(a), if income of a first-tier foreign corporation required to be included in the gross income of a domestic corporation under section 951(a) includes a dividend from a second-tier foreign corporation to the first-tier corporation, then such amount included in gross income of the domestic corporation under section 951 is considered as a dividend so that foreign taxes paid by the second-tier corporation and not already allowed as a credit may be deemed paid by the first-tier foreign corporation under section 902(b), and, in turn, then deemed paid by the domestic corporation under section 957(a).

Example (3).—M, a domestic corporation, wholly owns N, a controlled foreign corporation, which in turn wholly owns O, also a controlled foreign corporation but which has no income required to be included in any United States person's gross income. For taxable year 1970, O paid $40 in foreign taxes. O pays to N as a dividend its total earnings and profits of $60 for such taxable year, which dividend is N's only income and which in N's hands is foreign base company income required to be included in M's gross income under section 951(a). N has no deductions and pays no foreign taxes. The $60 required to be included in M's gross income is considered a dividend for purposes of applying section 902(b) with the result that N is deemed to have paid $40 in foreign taxes and M is in turn deemed to have paid $40 under section 957(a).

(*b*) *Special rules for foreign tax credit on receipt of previously taxed earnings and profits*.—Where a United States person receives a distribution which is excluded from income under section 956(a) because it was once taxed as income included in gross income of a United States person under section 951(a), the section 904 limitation is increased in the year of actual distribution so that a credit will be allowed for foreign taxes imposed on the income distributed after it was included in gross income under section 951. The United States person, however, must have either chosen the foreign tax credit in the taxable year in which such income was included in gross income under section 951(a), or else have paid or accrued in such year no income, war profits, or excess profits taxes to any foreign country or possession of the United States. He must also choose the foreign tax credit in the year of the receipt of the excluded distribution.

The amount of the increase in the section 904 limitation is an amount equal to the increase in such limitation which occurred in the taxable year of the inclusion of the income under section 951(a) solely by reason of such inclusion. Such amount is then reduced by the foreign taxes which were allowed as a credit in such year of the inclusion but which would not have been allowable but for such inclusion. The increase in the section 904 limitation may not exceed the income, war profits, or excess profits taxes paid, or deemed paid, or accrued with respect to the distribution in the taxable year such distribution is received.

Under paragraph (3) of section 957(b), a taxpayer who chose to take a foreign tax credit in the taxable year in which he was required to include income in gross income under section 951(a), but does not choose to take a foreign tax credit in the taxable year in which such

income is actually received, may not deduct under section 164 any income, war profits, or excess profits taxes paid or accrued on such income.

Under paragraph (4) of section 957(b), if the increase in limitation exceeds the U.S. tax for the taxable year, the excess is deemed an overpayment of tax for such year.

SECTION 958. ADJUSTMENTS TO BASIS OF STOCK IN CONTROLLED FOREIGN CORPORATION AND OTHER PROPERTY

To prevent doubling up of tax where stock in a controlled foreign corporation is sold at a gain which reflects the retained earnings already taxed to United States persons, the basis of stock would be adjusted.

(*a*) *Increase in basis.*—Subsection (a) provides that the basis of a United States person's stock in a controlled foreign corporation, and of property by reason of which he is treated as owning such stock in determining the amount which he must include in gross income under section 951, is increased by the amount included in gross income under section 951.

Example (*1*).—X, who owns stock in Y with a basis of $1,000, includes $50 of Y's income in gross income as required under section 951. The basis of X's stock in Y is increased to $1,050.

Example (*2*).—The facts are the same as in example (1) except that X is also required under section 951 to include in gross income $60 of the income of Z, a controlled foreign corporation wholly owned by Y. In such case the basis of X's stock in Y is increased to $1,110.

(*b*) *Reduction in basis.*—The basis of stock or other property with respect to which a United States person receives an amount which is excluded from gross income under section 956(a) is reduced by such amount. Thus, if X, in the last example above, received a distribution of $110 which was excluded from gross income under section 956(a) as the income previously taxed in such example, the basis of X's stock in Y would be reduced again to $1,000.

To the extent that an amount excluded from gross income under section 956 (a) exceeds the adjusted basis of stock or other property with respect to which it is received, it is treated as gain from the sale or exchange of the property.

(*b*) *Technical and clerical amendments.*—Paragraph (1) of this subsection amends section 551(b) (relating to foreign personal holding company income included in gross income of United States shareholders) to provide that the amount of undistributed foreign personal holding company income otherwise required to be included under section 551(b) in gross income of a United States person is reduced by his proportionate share of undistributed foreign personal holding company income included in gross income under section 951(a) for the taxable year as his proportionate share of subpart F income of such controlled foreign corporation.

Paragraphs (2), (3), (4), (5) and (6) make conforming changes.

(*c*) *Effective date.*—Subsection (c) provides that the amendments made by section 13 are to apply with respect to taxable years of foreign corporations beginning after December 31, 1962, and the taxable years of United States persons in which or with which such taxable years of such corporations end.

SECTION 14. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE PROPERTY

(*a*) *In general.*—Paragraph (1) of section 14(a) of the bill adds a new section 1245 to the 1954 Code. In general, the new section provides for the inclusion in gross income (as ordinary income) of the gain from the disposition of certain depreciable property, to the extent of depreciation deductions taken in taxable years beginning after December 31, 1961, which are reflected in the adjusted basis of such property.

SECTION 1245. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE PROPERTY

(*a*) *General rule.*—Paragraph (1) of section 1245(a) provides the general rule that if "section 1245 property" is disposed of after the date of the enactment of the Revenue Act of 1962, the amount by which the lower of "recomputed basis" or the amount realized (or the fair market value in transactions in which no amount is realized) exceeds the adjusted basis of the property is to be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231. The term "disposed of" includes any transfer or involuntary conversion.

Paragraph (2) of section 1245(a) defines recomputed basis as the adjusted basis of the property recomputed by adding thereto all adjustments, for taxable years beginning after December 31, 1961, reflected in such adjusted basis on account of deductions for depreciation, or for amortization under section 168, whether in respect of the same or other property and whether allowed or allowable to the taxpayer or any other person. For example, if a taxpayer purchases section 1245 property on January 1, 1963, at a cost of $10,000 and the taxpayer takes depreciation deductions of $2,000 (the amount allowable) before making a gift of the property to his son, the son's adjusted basis in the property for purposes of determing gain would, under the provisions of sections 1015 (relating to the basis of property acquired by gift) and 1016 (relating to adjustments to basis), be the same as his father's adjusted basis ($8,000), and the recomputed basis of the property in the son's hands would be $10,000 since the $2,000 of depreciation deductions taken by the father are reflected in the son's basis in the property. Thus, if the son later sells the property for $10,000, he would have $2,000 of gain to which section 1245(a) applies. Moreover, if the son himself takes $1,000 in depreciation deductions (the amount allowable) with respect to the property and then sells it for $10,000, he would have $3,000 of gain to which section 1245(a) applies.

While recomputed basis is determined with respect to adjustments to basis for deductions for depreciation (and for amortization under sec. 168) which were either allowed or allowable, if the taxpayer can establish by adequate records or other sufficient evidence that the amount allowed for any taxable year was less than the amount allowable, the amount to be added for such taxable year is the amount allowed. For example, assume that in the year 1967 it becomes necessary to determine the recomputed basis of property, the adjusted basis of which reflects an adjustment of $1,000 with respect to deprecia-

tion deductions allowable for the year 1963. If the taxpayer can establish by adequate records or other sufficient evidence that he had been allowed a deduction of only $800 for 1963, then in determining the recomputed basis, the amount added to adjusted basis with respect to the $1,000 adjustment to basis for 1963 will be only $800.

Paragraph (1) of section 1245(a) further provides that gain is to be recognized notwithstanding any other provision of subtitle A of the 1954 Code. Thus, other nonrecognition sections of the code are overridden by the new section. For example, the gain under such paragraph (1) would be recognized to a corporation in the case of a distribution of section 1245 property by it to a shareholder, notwithstanding the provisions of section 311(a) or 336. Likewise, gain under such paragraph (1) would be recognized to a corporation on a sale or exchange of such property, notwithstanding the provisions of section 337. The operation of section 1245 may, however, be affected by the taxpayer's method of accounting. For example, the gain from a disposition to which section 1245 applies may be reported by the taxpayer under the installment method if such method is otherwise available under section 453 of the code.

In the case of a disposition of section 1245 property in which an amount is realized (a sale, exchange, or involuntary conversion), the gain to which section 1245(a) applies is the amount by which the amount realized or the recomputed basis, whichever is lower, exceeds the adjusted basis of the property. In the case of any other disposition, the gain to which section 1245(a) applies is the amount by which the fair market value of the property on the date of disposition or its recomputed basis, whichever is lower, exceeds its adjusted basis. For example, if section 1245 property has an adjusted basis of $2,000 and a recomputed basis of $3,300 and is sold for $2,900, the gain to which section 1245(a) applies is $900 ($2,900 minus $2,000). If the property is sold for $3,700, the gain is $1,700, of which $1,300 ($3,300 minus $2,000) is gain to which section 1245(a) applies. If, on the other hand, the property is distributed by a corporation to a stockholder in a distribution to which section 1245(a) applies and at a time when the fair market value of the property is $3,100, the gain recognized to the corporation upon such disposition is $1,100 ($3,100 minus $2,000); if the fair market value is $3,800 at the time of such disposition, the gain to which section 1245(a) applies is $1,300 ($3,300 minus $2,000).

Paragraph (3) of section 1245(a) defines "section 1245 property." Section 1245 property is any property (other than livestock) of a type described in subparagraph (A) or (B) of such paragraph (3) which is or has been property of a character subject to the allowance for depreciation provided in section 167. Even though the property may not be subject to the allowance for depreciation in the hands of the taxpayer, such property is nevertheless subject to the provisions of section 1245(a) if the property was subject to the allowance for depreciation in the hands of any prior holder, and if such depreciation is taken into account in determining the adjusted basis of the property in the hands of the taxpayer.

The definition of section 1245 property is similar in certain respects to the definition of "section 38 property" contained in section 48(a) (relating to the investment credit). However, section 1245 property is a broader concept than section 38 property, since (for example)

the definition of section 1245 property is not subject to the minimum useful life provision in section 48(a)(1) or to the other limitation and exclusion provisions in paragraphs (2) through (5) of section 48(a). Moreover, the term "personal property" in subparagraph (A) of section 1245(a)(3) is intended to include not only "tangible personal property" as defined in section 48(a)(1)(A) but also intangible personal property.

Subparagraph (B) of section 1245(a)(3) describes other property (not including a building or its structural components) if such other property is tangible and has an adjusted basis in which there are reflected adjustments for depreciation or amortization under section 168 which would be taken into account in determining recomputed basis for a period in which such property (or other property) either (i) was used as an integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or (ii) constituted research or storage facilities used in connection with any such activities. The language in clauses (i) and (ii) in section 1245(a)(3)(B) is intended to have the same meaning as when used in clauses (i) and (ii) in section 48(a)(1)(B) (relating to the definition of sec. 38 property subject to the investment credit). Even though the property is not used by the taxpayer as an integral part of an activity specified in clause (i), or does not constitute research or storage facilities within the meaning of clause (ii), such property in certain circumstances may, nevertheless, be section 1245 property under subparagraph (B). An illustration of such a circumstance is when the adjusted basis of such property in the hands of the taxpayer reflects adjustments for depreciation with respect to such property taken for taxable years beginning after December 31, 1961, at a time when such property was used as an integral part of manufacturing by the taxpayer or another taxpayer. Another illustration is when the adjusted basis of such property in the hands of the taxpayer reflects adjustments for depreciation with respect to *other* property (as, for example, in the case of a like kind exchange under sec. 1031) taken for taxable years beginning after December 31, 1961, at a time when such other property was used as an integral part of manufacturing by the taxpayer.

(*b*) *Exceptions and limitations.*—Subsection (b) of section 1245 sets forth certain exceptions and limitations to the general rule provided in subsection (a). Paragraph (1) provides that subsection (a) will not apply to a disposition by gift. Paragraph (2) provides that, except as provided in section 691, subsection (a) will not apply to a transfer at death.

Paragraph (3) of section 1245(b) provides that if the basis of property in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of certain sections of the code providing for nonrecognition treatment, then the amount of gain taken into account by the transferor under subsection (a)(1) is to be limited to the amount of gain recognized by the transferor under these sections (determined without regard to sec. 1245). These nonrecognition provisions are: Section 332 (relating to distributions in liquidation of an 80 percent or more controlled subsidiary corporation); section 351 (relating to transfers to a corporation controlled by the transferor); section 361 (relating to exchanges pursuant

to certain corporate reorganizations); section 371(a) (relating to exchanges pursuant to certain receivership and bankruptcy proceedings); section 374(a) (relating to exchanges pursuant to certain railroad reorganizations); section 721 (relating to transfers to a partnership in exchange for a partnership interest); and section 731 (relating to distributions by a partnership to a partner). For example, assume that a taxpayer transfers section 1245 property to a corporation in exchange for cash of $1,000, and stock in the corporation worth $9,000, in a transaction qualifying under section 351. The property has a fair market value of $10,000, a recomputed basis of $8,000, and an adjusted basis of $4,000. Since under section 351(b) gain in the amount of $1,000 would be recognized to the transferor without regard to the new section 1245, subsection (b)(3) limits the gain taken into account by the transferor under section 1245(a) to $1,000. The basis of the property in the hands of the corporation under section 362(a) (relating to basis to corporations of property acquired by issuance of stock, etc.) will be $5,000, that is, the adjusted basis of the property in the hands of the transferor ($4,000) increased by the gain recognized to the transferor on the transfer ($1,000). If the corporation later sells the property for $10,000 without taking any deductions with respect to the property, the gain recognized to the corporation under subsection (a) will be $3,000, the excess of recomputed basis ($8,000) over adjusted basis ($5,000).

Since the limitation provided in subsection (b)(3) upon the gain recognized under subsection (a) is confined to instances of "carryover basis," in the case of the liquidation of an 80 percent or more controlled subsidiary the limitation is not applicable if the basis of the property in the hands of the parent corporation is determined under section 334(b)(2). Subsection (b)(3) does not apply to a disposition of property to an organization (other than a cooperative described in sec. 521) exempt from taxation under chapter 1 of the code, but no implication is intended as to whether a transfer to such an exempt organization could or could not qualify for nonrecognition under the sections of the code set forth in subsection (b)(3).

Paragraph (4) of section 1245(b) provides that if property is disposed of and gain (determined without regard to sec. 1245) is not recognized in whole or in part under section 1031 (relating to like kind exchanges) or 1033 (relating to involuntary conversions), then the amount of gain taken into account under section 1245(a) is not to exceed the sum of the amount of gain recognized on such disposition (determined without regard to sec. 1245) plus the fair market value of property acquired which is not section 1245 property and which is not otherwise taken into account in determining the gain under section 1031 or 1033. For example, assume that a taxpayer owns section 1245 property with an adjusted basis of $100,000 and a recomputed basis of $116,000. The property is destroyed by fire and the taxpayer receives $117,000 of insurance proceeds. He uses $105,000 of the proceeds to purchase property similar or related in service or use to the property destroyed in an acquisition qualifying under section 1033(a)(3)(A), and he uses $9,000 of the proceeds to purchase stock in the acquisition of control of a corporation owning property similar or related in service or use to the converted property, which acquisition also qualifies under section 1033(a)(3)(A). The taxpayer properly elects under section 1033(a)(3)(A) and the regulations thereunder to limit recognition of

gain to the amount by which the amount realized from the conversion exceeds the cost of the stock and other property acquired to replace the converted property. Since $3,000 of the gain is recognized (without regard to sec. 1245) under section 1033(a)(3) (that is, $117,000 minus $114,000), and since the stock purchased for $9,000 is not depreciable property and was not taken into account in determining the gain under section 1033, the amount of gain to be taken into account under section 1245(a) may not exceed $12,000. Thus, section 1245(a) applies to $12,000 of the $16,000 gain.

Paragraph (5) of section 1245(b) empowers the Secretary of the Treasury or his delegate to prescribe regulations setting forth rules consistent with paragraphs (3) and (4) in the case of transactions described in section 1071 (relating to gain from sale or exchange to effectuate policies of FCC) or section 1081 (relating to nonrecognition of gain or loss on exchanges or distributions in obedience to orders of SEC).

Paragraph (6)(A) provides that, for purposes of section 1245, the basis of section 1245 property distributed by a partnership to a partner will be deemed to be determined by reference to the adjusted basis of such property to the partnership. Paragraph (6)(B) provides that, for purposes of computing the recomputed basis of such property, the amount of the adjustments added back for periods before the distribution is the amount of gain to which section 1245(a) would have applied if such property had been sold by the partnership immediately before the distribution, reduced by the amount of such gain which resulted from the application of section 751(b). Thus, since the basis of section 1245 property distributed by a partnership to a partner is deemed to be a carryover basis, any subsequent disposition of the property which requires a computation of the recomputed basis would have to take into account adjustments to basis for depreciation deductions taken before the distribution. However, such adjustments are fixed at an amount equal to the gain to which section 1245(a) would have applied if the partnership had sold the property instead of distributing it, assuming no gain upon distribution arose out of the application of section 751(b).

The application of this provision is illustrated as follows: A, B, and C are equal partners in a partnership whose assets consist of three pieces of section 1245 property, assets X, Y, and Z, each with a fair market value of $100,000. Asset X has an adjusted basis of $60,000 and a recomputed basis of $85,000; asset Y has an adjusted basis of $85,000 and a recomputed basis of $110,000; and asset Z has an adjusted basis of $95,000 and a recomputed basis of $100,000. Asset Y is distributed to B in complete liquidation of his partnership interest. B's basis in his partnership interest is $75,000 and under section 732 this basis is allocated to asset Y. If B later sells asset Y for $103,000 at a time when the adjusted basis is still $75,000 and if B has not taken any depreciation deductions with respect to asset Y since the distribution, the gain to which section 1245(a) applies would be $15,000, since the recomputed basis of the property is only $90,000, that is, the adjusted basis of the property ($75,000) increased by the amount of gain ($15,000) which would have been recognized to the partnership if the asset had been sold for its fair market value at the time of distribution ($100,000 minus $85,000).

(*c*) *Adjustments to basis.*—Subsection (c) of section 1245 provides that the Secretary of the Treasury or his delegate is to prescribe such regulations as he may deem necessary to provide for adjustments to the basis of property to reflect gain to which section 1245(a) applies. This provision is necessary to prevent the same amount from being subjected to taxation more than once. For example, under existing law if a corporation distributes section 1245 property to a corporate shareholder, generally the amount of the distribution and the basis of the property in the hands of the corporate distributee is the fair market value of the property or its adjusted basis in the hands of the distributing corporation, whichever is lower. Under section 1245, however, the distribution may result in gain being recognized to the distributing corporation and unless the distributee is permitted to increase its carryover basis by the amount of the gain recognized to the distributor, the same gain may be subjected to tax when the distributee later sells the property. Therefore, under regulations prescribed by the Secretary of the Treasury or his delegate, adjustment will be made to the basis of the distributed property to reflect the gain recognized to the distributing corporation.

(*d*) *Application of section.*—Subsection (d) of section 1245 provides that the section is to apply notwithstanding any other provision of subtitle A of the code. Thus, section 1245 overrides any nonrecognition provision of subtitle A or any "income characterizing" provision. For example, the gain to which section 1245(a) applies might otherwise be considered as gain from the sale or exchange of a capital asset under section 1231 (relating to property used in the trade or business and involuntary conversions). Since section 1245 overrides section 1231, the gain to which section 1245(a) applies will be treated as ordinary income, and only the remaining gain, if any, from the property may be considered as gain from the sale or exchange of a capital asset if section 1231 is applicable. For example, assume that a taxpayer sells for $130 section 1245 property with an adjusted basis of $40 and a recomputed basis of $100. The excess of the recomputed basis over adjusted basis, or $60, will be treated as gain under section 1245(a). The excess of the selling price over recomputed basis, or $30, may be considered under section 1231 as gain from the sale of a capital asset.

Subsection (d) is not intended to prevent gain not recognized under section 1245 from being considered as gain under another provision of the code. For example, assume that a taxpayer purchases section 1245 property for $1,000 and for taxable years beginning on or before December 31, 1961, he takes deductions of $500 under section 168 (relating to amortization of emergency facilities). Assume that if section 168 had not applied the taxpayer would instead have taken depreciation deductions of $300. For taxable years beginning after December 31, 1961, the taxpayer takes additional deductions under section 168 of $400. Under these facts, if the property is then sold for $800, section 1245(a) would recognize gain to the extent of the $400 in deductions taken in taxable years beginning after December 31, 1961, but would not recognize gain to the extent of the deductions taken in prior taxable years. Nothing in subsection (d) prevents $200 of the remaining gain from being taxed under section 1238 (relating to amortization in excess of depreciation).

SECTION 14. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE PROPERTY—(Continued)

(*b*) *Change in method of depreciation.*—Subsection (b) of section 14 of the bill amends subsection (e) of section 167 of the 1954 Code (relating to depreciation). Paragraph (1) of section 167(e) is the same in substance as existing section 167(e). Paragraph (2), which is new, permits any taxpayer within such period after the date of the enactment of the Revenue Act of 1962 and in such manner as the Secretary of the Treasury or his delegate shall by regulations prescribe, to elect to change his method of depreciation in respect of section 1245 property from any declining balance or sum of the years-digits method to the straight-line method.

(*c*) *Salvage value of personal property.*—Subsection (c)(1) of section 14 of the bill adds a new subsection (f) to section 167 of the code (relating to depreciation) and redesignates subsections (f), (g), and (h) of section 167 as subsections (g), (h), and (i), respectively.

Paragraph (1) of section 167(f) provides the general rule that, under regulations prescribed by the Secretary of the Treasury or his delegate, a taxpayer may, for purposes of computing the allowance for depreciation with respect to personal property, reduce the amount taken into account as salvage value by an amount which does not exceed 10 percent of the basis of such property (as determined under sec. 167(g) as of the time as of which such salvage value is required to be determined). For example, a taxpayer purchases depreciable personal property on January 1, 1963, for $10,000. The estimated useful life of the property is 10 years and the estimated salvage value is $500. The taxpayer uses the straight-line method of depreciation. Under present law the taxpayer would take depreciation deductions of $950 in each of the 10 years of the useful life of the property. However, under section 167(f) the taxpayer may reduce salvage value, for purposes of computing the allowable depreciation deduction, by 10 percent of $10,000. Since this amount, $1,000, is greater than the estimated salvage value, $500, the salvage value may be reduced to zero and the taxpayer may deduct $1,000 in each year of the useful life of the property. In the above case, if the taxpayer had taken into account salvage value of only $700 but the estimated salvage value had actually been $1,500, the Internal Revenue Service could not adjust the amount used by the taxpayer since the reduction of salvage value by 8 percent of basis would be within the privilege granted by the new section 167(f).

Paragraph (2) of section 167(f) defines "personal property" as depreciable personal property (other than livestock) with a useful life of 3 years or more acquired after the date of the enactment of the Revenue Act of 1962.

(*d*) *Special rule for charitable contributions of section 1245 property.*—Subsection (d) of section 14 of the bill adds a new subsection (e) to section 170 of the code (relating to deductions for charitable contributions). Under the new subsection, the amount of a charitable contribution of section 1245 property will be reduced by the amount which would have been treated as gain to which section 1245(a) applied if the property had been sold at its fair market value instead of contributed to the charity. For example, a taxpayer owns depreciable property with an adjusted basis of $10,000, a recomputed

basis of $14,000, and a fair market value of $17,000. If the property were sold for $17,000, gain of $4,000 under section 1245(a) would result. Assume that the taxpayer contributes the property to a qualifying charitable organization. Under the new section 170(e) the amount of the charitable contribution would be $13,000 ($17,000 minus $4,000).

(*e*) *Technical amendments.*—Paragraph (1) of section 14(e) of the bill amends section 751(c) of the code to provide that, for purposes of section 751 (relating to unrealized receivables and inventory items), section 731 (relating to extent of gain or loss on distribution), section 736 (relating to payments to a retiring partner or a deceased partner's successor in interest), and section 741 (relating to recognition and character of gain or loss on sale or exchange), the term "unrealized receivables" will include section 1245 property, but only to the extent of the amount which would be treated as gain to which section 1245(a) applied if the property were sold by the partnership at its fair market value. Thus, the rules provided in section 751 with respect to unrealized receivables will also apply with respect to section 1245 property, to the extent of the potential section 1245(a) gain. For example, if a partner sold his interest in a partnership to a third party, the portion of the amount realized on such sale allocable to the partner's share of the potential section 1245(a) gain on the section 1245 property of the partnership will be recognized to the partner.

Paragraph (2) of section 14(e) of the bill amends section 301 (b) and (d) of the code (relating to the amount distributed and basis in a corporate distribution of property) by striking out "subsection (b) or (c) of section 311" and inserting in lieu thereof "subsection (b) or (c) of section 311 or under section 1245(a)."

Paragraph (3) of section 14(e) of the bill amends section 312(c)(3) (relating to adjustments to earnings and profits) by striking out "subsection (b) or (c) of section 311" and inserting in lieu thereof "subsection (b) or (c) of section 311 or under section 1245(a)."

Paragraph (4) of section 14(e) of the bill adds a new paragraph (12) to section 341(e) (relating to collapsible corporations). New paragraph (12) provides that, for purposes of section 341(e), the determination of whether gain from the sale or exchange of property would be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b) is to be made without regard to the application of section 1245(a).

Paragraph (5)(A) of section 14(e) of the bill adds a new sentence at the end of section 453(d)(4)(A), relating to distribution of installment obligations in complete liquidations of subsidiaries under section 332. Section 453(d)(4)(A) provides that if an installment obligation is distributed by one corporation to another corporation and if under section 332 no gain or loss is recognized to the recipient corporation with respect to the receipt of such obligation, then no gain or loss with respect to the distribution of such obligation is recognized to the distributing corporation. The new sentence provides that if section 334(b)(2) (relating to the basis of property received in certain liquidations to which sec. 332 applies) applies in respect of property received by the distributee corporation, then the rule of existing law is not to apply to the extent that under paragraph (1) of section 453(d) gain to the distributing corporation would be

considered as gain to which section 1245(a) applies. For example, assume that corporation X sells section 1245 property and returns its income therefrom on the installment method under section 453. Corporation Y then buys all the outstanding stock of X and within 2 years after the purchase X adopts a plan of complete liquidation. If an installment obligation received by X upon the sale of the section 1245 property is distributed to Y in the liquidation, gain will be recognized to X under paragraph (1) of section 453(d) to the extent that the excess of the fair market value of the obligation over its basis constitutes gain to which section 1245(a) applies.

Paragraph (5)(B) of section 14(e) of the bill adds a new sentence at the end of section 453(d)(4)(B), relating to distribution of installment obligations in liquidations to which section 337 applies. Section 453(d)(4)(B) provides that if an installment obligation is distributed by a corporation in the course of a liquidation and if under section 337 no gain or loss would have been recognized to the corporation if the corporation had sold or exchanged such obligation on the day of the distribution, then no gain or loss is recognized to the corporation by reason of the distribution. The new sentence provides that the preceding rule is not to apply to the extent that under paragraph (1) of section 453(d) gain to the distributing corporation would be considered as gain to which section 1245(a) applies. For example, assume that corporation X, which makes its return on the basis of the fiscal year ending June 30, adopts a plan of complete liquidation on March 15. On June 15, X sells section 1245 property and returns its income therefrom on the installment method under section 453. On October 15, X distributes all of its property (including an installment obligation received in respect of the sale) in complete liquidation. Gain will be recognized to X under paragraph (1) of section 453(d) to the extent that the excess of the fair market value of the installment obligation over its basis constitutes gain to which section 1245(a) applies.

(*f*) *Effective date.*—Subsection (f) of section 14 of the bill provides that the amendments made by section 14 shall apply to taxable years beginning after December 31, 1961, and ending after the date of the enactment of the bill.

SECTION 15. FOREIGN INVESTMENT COMPANIES

(*a*) *Treatment of sale of stock of foreign investment companies.*—Subsection (a)(1) of section 15 of the bill adds to part IV of subchapter P of chapter 1 of the code (relating to special rules for determining capital gains and losses) two new sections, section 1246 (relating to gain on foreign investment company stock) and section 1247 (relating to election by foreign investment companies to distribute income currently).

Section 1246 provides for the inclusion as ordinary income of certain gains from the sale or exchange of stock in a foreign investment company. However, section 1246 will not apply if, under section 1247, the foreign investment company elects to fulfill the requirements of such section and such shareholders include in computing their long-term capital gains, their share of the company's net long-term capital gains over the net short-term capital losses, whether or not distributed.

SECTION 1246. GAIN ON FOREIGN INVESTMENT COMPANY STOCK

(*a*) *Treatment of gain as ordinary income.*—Under subsection (a)(1) of section 1246, any gain from the sale or exchange after December 31, 1962, of stock to which the subsection applies is to be treated as gain from the sale or exchange of property which is not a capital asset, but only to the extent of the taxpayer's ratable share of the earnings and profits of the company accumulated for taxable years beginning after December 31, 1962. Any additional gain or any loss on the sale or exchange of such stock will remain unaffected by these provisions. Subsection (a)(1) applies to stock in a foreign corporation which was a foreign investment company at any time during the period during which the taxpayer held such stock. Thus subsection (a)(1) applies whether or not the foreign corporation is within the definition of a foreign investment company at the time of the sale or exchange. However, since under section 15(c) of the bill, section 1246 applies only with respect to taxable years beginning after December 31, 1962, the corporation must have been a foreign investment company while the taxpayer held the stock at some time during such a taxable year.

Subsection (a)(2) of the new section 1246 provides that the taxpayer's ratable share of the accumulated earnings and profits is to be determined under regulations prescribed by the Secretary of the Treasury or his delegate. Such determination is to include only the taxpayer's ratable share of the earnings and profits of the foreign corporation accumulated for the period during which the taxpayer held stock in such foreign corporation (excluding any portion of such period occurring in a taxable year of the corporation beginning before January 1, 1963). Such determination will exclude the taxpayer's share of undistributed earnings and profits which previously had been taxed to him under section 951 (relating to amounts included in gross income of United States persons, added by sec. 13 of the bill) or under section 551 (relating to foreign personal holding company income taxed to United States shareholders). The amount of the accumulated earnings and profits for any period is determined after applying the rules of the code that distributions are treated as made out of the most recently accumulated earnings and profits.

Subsection (a)(3) of the new section 1246 requires the taxpayer to establish the amount of the accumulated earnings and profits of the foreign corporation and his ratable share of such amount. He must establish this information for the period during which he held such stock, including whatever holding period is required by other subsections of section 1246. Failure to establish this information will result in all the gain from the sale or exchange of such stock being considered as gain from the sale or exchange of property which is not a capital asset.

Subsection (a)(4) of the new section 1246 provides that section 1246 is not to apply where the holding period of the stock as of the date of the sale or exchange is 6 months or less.

(*b*) *Definition of foreign investment company.*—Under subsection (b) of section 1246 a foreign investment company is defined as a foreign corporation which meets one of two tests. The first test is met if the foreign corporation is registered under the Investment Company Act of 1940, as amended (15 U.S.C. 80a–1 to 80b–2), either as a management company or as a unit investment trust. Under the Investment Company Act of 1940, an investment company organized or created under the laws of a foreign country is required to register with the Securities and Exchange Commission in order to make a public offering of its securities in the United States. The Act defines an investment company, in general, as any issuer of securities which is or holds itself out as being engaged primarily in the business of investing, reinvesting, or trading in securities. Under the second test provided by the new section 1246(b), a foreign corporation, even though it does not make a public offering of its securities and does not register under the Act, is a foreign investment company if it comes within the definition of an investment company described above at a time when more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock, was held directly or indirectly (within the meaning of sec. 955(a) of the code, added by sec. 13 of the bill), by United States persons (as defined in sec. 7701(a)(30) of the code, added by sec. 9(h) of the bill). Under the Investment Company Act of 1940, the term "security" is defined broadly and includes among others, stock, Treasury stock, bond, debenture, any evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, certificate of deposit for a security, or a fractional undivided interest in oil, gas, or other mineral rights.

(*c*) *Stock having transferred or substituted basis.*—Subsection (c) of new section 1246 provides that stock in a foreign corporation, the basis of which (in the hands of the taxpayer selling or exchanging such stock) is determined by reference to the basis (in such taxpayer's hands or any other person's hands) of stock in a foreign investment company, will to the extent provided in regulations prescribed by the Secretary of the Treasury or his delegate be treated as stock of a foreign investment company. The stock which is so treated will be considered under section 1223 (relating to holding period of property) to be held by the taxpayer throughout the period during which the foreign investment company stock was held in addition to the period during which the stock in the foreign corporation is held. Transactions to which subsection (c) applies include the following:

A person owning stock in a foreign investment company transfers such stock to foreign corporation F which he controls in exchange for stock of Corporation F in a transaction to which section 351 applies. Clearance under section 367 is obtained. The stock of Corporation F received in exchange for the foreign investment company stock will be considered stock of a foreign investment company. If the stock of Corporation F is later transferred by gift, the donee will

also treat such stock as stock of the foreign investment company and the holding period of the donee will include the period during which the donor held the stock in the foreign investment company and Corporation F.

(*d*) *Rules relating to entities holding foreign investment stock.*—Subsection (d) of the new section 1246 provides that to the extent provided in regulations prescribed by the Secretary of the Treasury or his delegate, trust certificates of a trust to which section 677 (relating to income for benefit of grantor) applies, or stock in a domestic corporation, will be treated as stock of a foreign investment company to the extent that such trust or corporation has an investment in stock in a foreign investment company. As a result of this provision the taxpayer is deemed to be holding stock of the foreign investment company. The trust certificates or stock are to be treated under section 1223 as held by the taxpayer throughout the holding period for which the trust or domestic corporation held stock in a foreign investment company, but limited to the period during which the taxpayer held such trust certificates or stock in the domestic corporation. Such stock is deemed to be held by him in the same proportion that the actual investment in stock in a foreign investment company by the trust or domestic corporation bears to the total assets of such trust or domestic corporation. For example, if a domestic corporation has an investment of $20,000 in stock of a foreign investment company and total assets of $100,000, the proportion of the domestic corporation's investment is 20 percent. Therefore 20 percent of each share of stock in such corporation will be deemed to be foreign investment stock and 20 percent of the gain, if any, resulting from the sale or exchange thereof will be subjected to section 1246 treatment.

(*e*) *Rules relating to stock acquired from a decedent.*—Paragraph (1) of subsection (e) sets forth the manner for computing the basis of stock in a foreign investment company which is acquired from a decedent dying after December 31, 1962, and treats the holding period by the heir or successor in the manner provided for in subsection (c). Under paragraph (1) of subsection (e) the stock's basis determined under section 1014 will be reduced by the decedent's ratable share of the company's earnings and profits accumulated in taxable years beginning after December 31, 1962. For example, if the stock had an adjusted basis of $100, a fair market value of $150 on the date of the decedent's death, and $30 was the decedent's ratable share of the accumulated earnings and profits during the period he held such stock after December 31, 1962, the person acquiring the stock from the decedent would have a basis of $120 ($150—$30). In no case is the basis determined under section 1014 to be reduced below the adjusted basis of the stock in the hands of the decedent immediately before his death, regardless of the decedent's ratable share of such earnings. Thus, in the above example, the basis could not be reduced below $100.

The stock so acquired from a decedent shall be treated as if it were held throughout the holding period of the decedent in addition to the holding period of the person acquiring the stock. Thus, in effect the holding period of the decedent is tacked onto that of the person acquiring the stock. If, in the example illustrated in the preceding paragraph, the stock were sold immediately after acquisition at its

fair market value of $150, the gain of $30 ($150−$120) would be treated as gain from the sale of property which is not a capital asset. If, after acquisition the stock further increased in value, upon a sale or exchange, $30 plus the portion of the gain which is equal to the taxpayer's ratable share of the accumulated earnings and profits of the corporation for the period during which he held such stock would be treated in the same manner.

In the event the decedent's executor decides to determine the gross estate under section 2032 (relating to alternate valuation), for purposes of section 1246(e), the date the stock is so valued will be considered the date of the decedent's death. Therefore, the basis determined at such later date will be reduced by the decedent's ratable share of the earnings and profits accumulated during the period preceding the date of his death and the earnings and profits accumulated during the period between such date and the date of alternate valuation.

Paragraph (2) of section 1246(e) provides that if foreign investment company stock acquired from a decedent is sold or exchanged at a gain which gain is subject to ordinary income treatment under subsection (a) of section 1246, the taxpayer, under regulations prescribed by the Secretary of the Treasury or his delegate, is to be allowed a deduction from gross income, for the taxable year of the sale or exchange, equal to that portion of the decedent's estate tax deemed paid which is attributable to the excess of (A) the value at which such stock was taken into account for purposes of determining the value of the decedent's gross estate, over (B) the value at which it would have been so taken into account if such value had been reduced by the amount representing the reduction in basis described in paragraph (1). The value determined in (B) is actually the taxpayer's basis of the stock as determined under section 1246(e)(1). The provision of paragraph (1) may be illustrated by the following example:

Example.

The gross estate of a decedent dying in 1963 was $125,000, which included foreign investment company stock valued at $5,000. Assuming deductions of $10,000 and an exemption of $60,000, the taxable estate amounted to $55,000. The estate tax paid on this amount is $8,250. Assuming that the decedent's share of earnings and profits accumulated after December 31, 1962, was $500 the heir's basis for such stock determined under section 1246(e)(1) would be $4,500. If the heir sold such stock in 1963, he is allowed to deduct the following amount from his 1963 gross income:

Estate tax actually paid (on taxable estate of $55,000)	$8, 250
Less: Estate tax computed by reducing the gross estate by $500 (tax on taxable estate of $54,500)	8, 125
Amount deducted from the heir's gross income	125

If in 1963, the heir had sold only one-half of the stock, then only $62.50 (½ of $125) could have been deducted from his gross income.

(*f*) *Information with respect to certain foreign investment.*—Subsection (f) of section 1246 requires certain United States shareholders of a foreign investment company to furnish with respect to such company such information as the Secretary of the Treasury or his delegate shall by regulations prescribe. The requirement is applicable only to those United States persons who on the last day of the taxable year of a

foreign investment company beginning after December 31, 1962, own 5 percent or more in value of the stock of such company.

(*g*) *Cross reference.*—Subsection (g) of section 1246 is a cross reference to section 312(l) of the code (relating to effect on earnings and profits of foreign investment companies) which is added by section 15(b)(1) of the bill.

SEC. 1247. ELECTION BY FOREIGN INVESTMENT COMPANIES TO DISTRIBUTE INCOME CURRENTLY

Section 1247 provides that section 1246 will not apply to the shareholders of a registered foreign investment company if such company makes the election provided for by section 1247, and if the shareholders include in their income their proportionate share of the company's long-term capital gain.

(*a*) *Election by foreign investment company.*—Section 1247(a)(1) provides that if a foreign investment company of the type defined in section 1246(b)(1) (relating to registered foreign investment companies) makes the election provided by section 1247, section 1246 will not apply with respect to its qualified shareholders during any taxable year of the company to which the election is effective. Such election must be made on or before December 31, 1962, in the manner provided in regulations prescribed by the Secretary of the Treasury or his delegate. The election commits the company to fulfill the requirements provided in subparagraphs (A), (B), and (C) of subsection (a)(1) for each taxable year beginning after December 31, 1962.

Under subparagraph (A), the company elects to distribute to its shareholders at least 90 percent of its taxable income. For this purpose, taxable income is the amount determined as if such company were a domestic corporation but with the adjustments provided in subparagraph (A) of paragraph (2).

Under subparagraph (B), the company elects to designate, in a written notice mailed to its shareholders at any time before 30 days after the close of its taxable year, the pro rata amount of any excess of net long-term capital gains over net short-term capital losses and the portion thereof which is being distributed. Such determinations are to be made as if such company were a domestic corporation.

Under subparagraph (C), the company elects to provide such information as the Secretary of the Treasury or his delegate deems necessary to carry out the purposes of section 1247.

Paragraph (2)(A) of subsection (a) provides special rules for computing taxable income under paragraph (1)(A).

Subparagraph (A) states that such taxable income will be determined without regard to—

(i) the excess of the net long-term capital gains over net short-term capital losses for the taxable year,

(ii) the net operating loss deduction under section 172, and

(iii) the deductions provided in part VIII of subchapter B (relating to special deductions for corporations), other than the deduction provided in section 248 (relating to organizational expenses).

Paragraph (2)(B) provides that in determining the amount of the distribution made under paragraph (1)(A), a distribution made after the close of the taxable year but on or before the 15th day of the third

month of the next taxable year will be considered as distributed during the earlier year to the extent elected by the company on or before the 15th day of such third month. Such election is to be made in accordance with regulations prescribed by the Secretary of the Treasury or his delegate.

Subparagraph (C) of paragraph (2) provides that for purposes of making the computations under paragraph (1)(B), any capital loss under section 1212 incurred prior to the first effective year of the election will not be carried forward to the period for which the election is effective.

(*b*) *Years to which election applies.*—Subsection (b) of the new section 1247 provides that the election is to terminate as of the close of the taxable year preceding its first taxable year in which—

(1) the company fails (unless it is shown that such failure is due to reasonable cause and not due to willful neglect) at any time to comply with any of the requirements set forth in subsection (a)(1),

(2) the company is a foreign personal holding company, or

(3) the company is not a registered foreign investment company as described in section 1246(b)(1).

(*c*) *Qualified shareholders.*—Paragraph (1) of subsection (c) of section 1247 defines a "qualified shareholder" to mean a shareholder who is a United States person (as defined in sec. 7701(a)(30), added by sec. 9(h) of the bill) other than a shareholder described in paragraph (2) of subsection (a) of section 1247.

Paragraph (2) provides that a United States person is not to be treated as a qualified shareholder for the taxable year if for such taxable year (or for any prior taxable year) he fails to include (in computing his long-term capital gains in his return for such taxable year) the amount designated by the company as his share of the company's undistributed capital gains for its taxable year ending within or with the shareholder's taxable year. Once a taxpayer fails to comply with the provisions of this paragraph in determining his status as a qualified shareholder, he loses the benefits of a qualified shareholder for the duration of the election and section 1246 will apply when he sells or exchanges the stock of the foreign investment company at a gain. However, if a taxpayer can show that the failure to include his share of the undistributed capital gains in his return was due to reasonable cause and not due to willful neglect, he will continue to be treated as a qualified shareholder.

(*d*) *Adjustments.*—Subsection (d) of the new section 1247 provides that when undistributed capital gains are included in the qualified shareholder's gross income, adjustments must be made (1) in the earnings and profits of the electing foreign investment company, and (2) to the adjusted basis of his stock to reflect the inclusion in his gross income of such gains. Such adjustments are to be made in accordance with regulations prescribed by the Secretary of the Treasury or his delegate.

(*e*) *Loss on sale or exchange of certain stock held less than 6 months.*—If a share of stock is held by a qualified shareholder for less than 6 months and if he treats any amount designated under section 1247(a)(1)(B) as long-term capital gain with respect to such shares, then subsection (e) of section 1247 requires any loss on the sale or exchange of such share (to the extent of the amount so treated as long-term capital gain) to be treated as loss from the sale or exchange of a capital

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asset held for more than 6 months. For example, on December 20, 1963, A purchases a share of stock in Corporation F, an electing foreign investment company, for $50. Corporation F (which is on a calendar year basis) designates A's share of its long-term capital gains for the year 1963 as being $5. No distribution with respect to capital gains is made. A, therefore, includes $5 in computing his long-term capital gains in his return for 1963. On January 10, 1964, A sells such share for $49. Since A has a basis of $55 (the $50 original cost plus the $5 capital gain included in income but not distributed) the sale results in a loss of $6. Subsection (e) treats $5 of this loss as a long-term capital loss.

SECTION 15. FOREIGN INVESTMENT COMPANIES (Continued)

(*b*) *Conforming amendments.*—Paragraph (1) of section 15(b) of the bill amends section 312 of the 1954 Code (relating to effect on earnings and profits) by adding after subsection (k) thereof a new subsection (l).

Paragraph (1) of subsection (l) provides that upon the sale or exchange of stock in a foreign investment company by a shareholder who is a United States person, if such foreign investment company is a member of an affiliated group (as defined in par. (2)), then the accumulated earnings and profits of all member companies are to be allocated under regulations prescribed by the Secretary of the Treasury or his delegate, in such a manner as to carry out the purposes of section 1246.

Paragraph (2) of subsection (l) defines the term "affiliated group" for purposes of subsection (l)(1) to have the same meaning as such term has in section 1504(a) except that (A) "more than 50 percent" is substituted for "80 percent or more" wherever appearing in section 1504(a), and (B) all corporations are treated as includible corporations without regard to section 1504(b).

Paragraph (3) of new subsection (l) provides a rule governing the reduction in the earnings and profits of a foreign investment company as a result of amounts distributed by a foreign investment company in a partial liquidation or in redemptions to which section 302(a) or 303 applies. The portion of the distribution which is chargeable to earnings and profits shall be an amount which is not in excess of the redeemed stock's ratable share of the earnings and profits of the company accumulated after February 28, 1913. The effect of this provision is to allocate to each share of stock (whether or not redeemed) an equal amount of the company's accumulated earnings and profits at the time of the redemption. Paragraph (3) of subsection (l) applies only to such distributions made after December 31, 1962. The application of subsection (l)(3) of section 312 may be illustrated by the following example: Corporation F, a foreign investment company, has accumulated earnings and profits of $10,000 on December 31, 1963, on which date Corporation F redeems shareholder A's stock for cash in the amount of $4,000. A is a 20-percent shareholder. Under the amendment the earnings and profits of the corporation are reduced by only $2,000 (20 percent of $10,000).

Paragraph (2) of section 15(b) of the bill amends section 751(d)(2) of the code (relating to inventory items of a partnership which have

appreciated substantially in value) by adding new subparagraphs (C) and (D) which provide treatment for the sale or exchange of an interest in a partnership which holds stock in a foreign investment company. The amendment treats foreign investment company stock as an inventory item of the partnership under subsection (d)(2) of section 751. If an interest in a partnership, holding stock in a foreign investment company, is sold or exchanged, and if section 1246(a) would apply to the gain on the sale or exchange of such stock were such stock sold or exchanged by the partnership, the amount received for such interest which is attributable to the inventory items under section 75(d)(2) (including foreign investment company stock) will be taxed at ordinary income rates, provided under section 751(d)(1) the substantial appreciation tests for inventory items of the partnership are satisfied.

Paragraph (3) of section 15(b) of the bill amends section 1223 of the code (relating to holding period of property) by redesignating paragraph (10) as paragraph (11) and adding a new paragraph (10). Paragraph (10) requires a taxpayer in determining the period for which he held certain trust certificates to which section 1246(d) applies (relating to entities holding foreign investment company stock), or the period for which he held stock to which such section applies, to include the period for which the trust or corporation held the stock of foreign investment companies.

(c) *Effective date.*—Subsection (c) of section 15 of the bill provides that the amendments made by section 15 are to apply with respect to taxable years beginning after December 31, 1962.

SECTION 16. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS

(a) *Treatment of gain from the redemption, cancellation, or sale of stock in certain foreign corporations.*—Subsection (a) of section 16 of the bill amends part IV of subchapter P of chapter 1 (relating to special rules for determining capital gains and losses) by adding after section 1247 (as added by sec. 15 of the bill) a new section 1248.

Redemptions and liquidations

Subject to the limitations of subsection (c), subsection (a) of the new section 1248 applies to (1) redemptions of stock in foreign corporations which are treated as exchanges under section 302(a), including redemptions to which section 304 applies; (2) cancellation of stock in complete liquidation of foreign corporations which are treated as exchanges under section 331(a)(1), including liquidations of subsidiary corporations if section 332 does not apply; and (3) cancellation of stock in partial liquidation of foreign corporations which are treated as exchanges under section 331(a)(2). The new section 1248 does not apply to a distribution in redemption of stock to which section 302(d) applies, or to a distribution of property to which section 303 applies.

Subsection (a) provides that United States persons (as defined in sec. 7701(a)(30) of the code, as added by sec. 9(h) of the bill) realizing gain on such exchanges are required to include in gross income as a dividend so much of the gain as is equal to the United States person's proportionate share of the earnings and profits of the foreign

corporation accumulated after February 28, 1913. That part of the gain in excess of such amount is not affected by the bill.

A United States person's proportionate share of earnings and profits is determined on the basis of his percentage of stock ownership on the date of redemption, liquidation, or partial liquidation, or if a distribution is one of a series of distributions in redemption of all the stock of a corporation at the date of each redemption. Thus, if a United States person owns 100% of the stock of a foreign corporation on the date a foreign corporation is liquidated, the gain realized on the exchange, to the extent of 100% of the earnings and profits of the foreign corporation, would be included in gross income as a dividend.

To the extent gain is included in gross income as a dividend, the applicable rules of subpart A of part III of subchapter N, relating to foreign tax credits, apply. Thus, foreign tax credits for amounts allowed under section 901(b) with respect to taxes paid, and section 902 with respect to taxes deemed to be paid, are allowable if the United States person chooses to have the benefits of such sections. The rules of section 11 of the bill, relating to the gross-up of dividends from foreign corporations, apply to dividends under this section in the same manner and to the same extent as section 11 applies to any other dividend. There is no foreign tax credit with respect to any taxes paid by the foreign corporation as to the portion of the gain which is not treated as a dividend.

The basis of property received in a distribution to which subsection (a) applies will continue to be determined under existing law relating to such taxable exchanges.

Sales and other exchanges

Subject to the limitations of subsection (c), subsection (b) of the new section 1248 applies to all sales of stock in foreign corporations, and to all taxable exchanges of stock in foreign corporations, other than exchanges to which subsection (a) applies, in which gain is realized.

If a United States person sells or exchanges stock in a foreign corporation, the gain recognized is treated as gain from the sale or exchange of property which is not a capital asset to the extent of such person's proportionate share of the earnings and profits of the foreign corporation accumulated during the period the stock sold or exchanged was held by such United States person. For this purpose, earnings and profits are determined on the basis of the time each share of stock sold or exchanged was held, as determined under section 1223. Thus, if 100% of the stock of a foreign corporation was held for five years, and if 50% was held for the prior five-year period, the United States person's proportionate share of the earnings and profits would be the total earnings and profits for five years and 50% of the earnings and profits for the prior five-year period. That part of gain in excess of such amount is treated as provided by the code without regard to the new section 1248.

The earnings and profits of a foreign corporation are not reduced by any amount included in gross income under subsection (b).

Limitations

Subsection (c) of new section 1248 contains six limitations on the application of the general rules of subsections (a) and (b). In addition to these limitations, section 1248 would be inapplicable to exchanges described in sections 332, 351, 354, 355, 356, or 361 of the code if before such exchange, as prescribed in section 367, it has been established to the satisfaction of the Secretary of the Treasury or his delegate that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

Paragraph (1) provides that subsections (a) and (b) apply to a sale or exchange of stock in a foreign corporation only if the foreign corporation is a controlled foreign corporation, as defined in section 954 (added by sec. 13 of the bill), on the date of the sale or exchange, or, if not a controlled foreign corporation on such date, if the foreign corporation was a controlled foreign corporation on any day in the five-year period ending on the date of sale or exchange.

Paragraph (2) provides that subsections (a) and (b) apply to a sale or exchange of stock in a foreign corporation (subject to the limitations of par. (1)) only if the United States person whose stock is sold or exchanged can be considered, by applying the rules of constructive ownership of section 955 (added by sec. 13 of the bill), as being the owner, directly or indirectly, of 10% or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation on the date of sale or exchange or at any time during the five-year period ending on the date of the sale or exchange. It is not necessary that the United States person own such amount of stock on the date of sale or exchange or have owned such amount on a day when the foreign corporation was a controlled foreign corporation.

Paragraph (3) of section 1248(c) correlates section 1248 with section 951 (added by sec. 13 of the bill) by reducing the amount of gain considered a dividend under subsection (a), or as gain from the sale or exchange of property which is not a capital asset under subsection (b), by the United States person's proportionate share of earnings and profits of the foreign corporation, attributable to the stock sold or exchanged, previously included in the gross income of the United States person by the application of subpart F of part III of subchapter N. However, amounts previously included in the gross income of the United States person under section 951 are reduced by amounts subsequently distributed by the foreign corporation and excluded from gross income of the United States person under section 956.

The application of this paragraph may be illustrated by the following example involving United States person X who owns 100% of the stock of foreign corporation A. X purchased the stock on January 1, 1964 for $100,000 and sold the stock on January 1, 1966 for $115,000. For the year 1964, corporation A had subpart F income of $10,000 which was included in the gross income of X under section 951. Corporation A had no earnings and profits for the year 1965, but made a $5,000 distribution out of 1964 earnings and profits and thus excludible from gross income of X under section 956. For the year 1966, X

is required to include $10,000 in gross income as a long-term capital gain, which amount is computed as follows:

(i) Amount of gain:		
(a) Amount realized		$115, 000
(b) Adjusted basis:		
Cost	$100, 000	
Increased by amount included in gross income under section 951 (sec. 958(a))	10, 000	
	110, 000	
Reduced by amount excluded from gross income under section 956 (sec. 958(b))	5, 000	
Adjusted basis		105, 000
(c) Amount of gain ((a) minus (b))		10, 000
(ii) Amount of gain considered as gain from the sale or exchange of property which is not a capital asset (sec. 1248(b)):		
(a) X's proportionate share of earnings and profits accumulated during the period the stock sold was held by X ($10,000 of earnings and profits for 1964, reduced by $5,000 distributed during 1965)	$5, 000	
(b) X's proportionate share of earnings and profits previously included in the gross income of X under section 951 ($10,000, reduced by distributions excluded from the gross income of X under section 956, $5,000)	5, 000	
(c) Gain—considered as gain from the sale or exchange of property which is not a capital asset ((a) minus (b))		0
(iii) Amount of gain from the sale of a capital asset held for more than 6 months (item (i) minus item (ii))		10, 000

Paragraph (4) provides that subsections (a) and (b) do not apply to a distribution of property to a United States person by a foreign corporation in redemption of part or all of the stock of such corporation to which section 303, relating to distributions in redemption of stock to pay death taxes, applies.

Paragraph (5) provides that subsection (b) does not apply to gain recognized because of the receipt of additional consideration on exchanges to which section 356 applies.

Paragraph (6) provides that the amount includible in gross income under subsections (a) or (b) shall not include any amount treated as a dividend, as gain from the sale of an asset which is not a capital asset, or as gain from the sale of an asset held for not more than six months, under any other provision of the code.

Taxpayer to establish earnings and profits

Subsection (d) of the new section 1248 provides that the United States person selling or exchanging the stock must establish the amount of earnings and profits of the foreign corporation to be taken into account under subsections (a) and (b). If the United States person does not establish the amount of earnings and profits to be taken into account, his entire gain is treated as a dividend under subsection (a), or as gain from the sale or exchange of property which is not a capital asset under subsection (b), whichever is applicable.

(*b*) *Clerical amendment.*—Subsection (b) of section 16 of the bill conforms the table of sections for part IV of subchapter P to the amendment made by subsection (a) of section 16 of the bill.

(*c*) *Effective date.*—Subsection (c) of section 16 of the bill provides that the amendments made by section 16 are to apply with respect to sales or exchanges occurring after the date of the enactment of the bill.

SECTION 17. TAX TREATMENT OF COOPERATIVES AND PATRONS

(*a*) *In general.*—Subsection (a) of section 17 of the bill amends the Internal Revenue Code of 1954 by adding to chapter 1 a new subchapter T (relating to cooperatives and their patrons) consisting of part I, tax treatment of cooperatives, part II, tax treatment by patrons of patronage dividends, and part III, definitions and special rules.

PART I—TAX TREATMENT OF COOPERATIVES

Part I of subchapter T consists of section 1381, organizations to which such part applies, section 1382, taxable income of cooperatives, and section 1383, computation of tax where cooperative redeems nonqualified written notices of allocation.

SECTION 1381. ORGANIZATIONS TO WHICH PART APPLIES

(*a*) *In general.*—Subsection (a) of section 1381 provides that part I of subchapter T is to apply to any organization which is exempt from tax under section 521 (relating to exemption of farmers' cooperatives) and to any corporation operating on a cooperative basis. Part I is not applicable, however, to any organization (1) which is exempt from income taxes (other than an exempt farmers' cooperative described in sec. 521); (2) which is subject to the provisions of part II of subchapter H (relating to mutual savings banks, etc.); (3) which is subject to the provisions of subchapter L (relating to insurance companies); or (4) which is engaged in furnishing electric energy, or providing telephone service, to persons in rural areas. Thus, part I of the new subchapter T does not apply to any cooperative exempt from tax under section 501. Nor does it apply to a cooperative which generates or transmits electricity for use by persons living in rural areas.

(*b*) *Tax on certain farmers' cooperatives.*—Subsection (b) of section 1381 provides that the farmers' cooperatives described in section 521 are subject to corporate income taxes. This is the same provision as the provision presently contained in section 522.

SECTION 1382. TAXABLE INCOME OF COOPERATIVES

(*a*) *Gross income.*—Subsection (a) of section 1382 provides that, except as provided in section 1382(b), all cooperatives to which part I of the new subchapter T applies must compute gross income without any adjustment (as a reduction in gross receipts, an increase in cost of goods sold, or otherwise) for amounts allocated or distributed to patrons out of net earnings.

(*b*) *Patronage dividends.*—Subsection (b)(1), applicable to both taxable and exempt cooperatives, provides that in determining the taxable income of a cooperative there are not to be taken into account

certain patronage dividends paid in money, qualified written notices of allocation, or other property (other than nonqualified written notices of allocation). Under this subsection, the patronage dividends which are not to be taken into account in computing taxable income for a taxable year are those which are paid during the payment period for that taxable year (as defined in sec. 1382(d)) with respect to patronage occurring during such taxable year.

Under subsection (b)(2), also applicable to both taxable and exempt cooperatives, certain amounts paid in money or other property (except written notices of allocation) in redemption of nonqualified written notices of allocation are not to be taken into account in determining the taxable income of a cooperative. The amounts described in subsection (b)(2) which are not to be taken into account for a taxable year are those which are paid during the payment period for that taxable year in redemption of nonqualified written notices of allocation which were paid as patronage dividends during the payment period for the taxable year during which the patronage occurred.

Subsection (b) also provides that amounts described in such subsection which are not taken into account in determining taxable income are to be treated for purposes of the 1954 Code in the same manner as items of gross income and corresponding deductions therefrom. Thus, for example, in determining the amount omitted from gross income for purposes of section 6501(e) (relating to period of limitations where there are omissions from gross income), amounts paid as patronage dividends (though not required to be taken into account in determining taxable income) are to be treated as amounts properly includible in gross income.

(c) *Deduction for nonpatronage distributions, etc.*—In the case of a farmers' cooperative which is exempt under section 521, certain deductions (in addition to other deductions allowed under chapter 1) are allowed under subsection (c) of the new section 1382. Subsection (c)(1) allows a deduction for dividends paid by such a cooperative during the taxable year on its capital stock. This deduction is the same in substance as that currently allowed under section 522(b)(1)(A).

Subsection (c)(2)(A) allows a deduction for amounts paid during the payment period for a taxable year, on a patronage basis, out of earnings of that taxable year derived either from business done for the United States or from sources other than patronage. A deduction is allowed by subsection (c)(2)(A), however, only for amounts paid in money, qualified written notices of allocation, or other property (except nonqualified written notices of allocation). For purposes of the deduction allowed by subsection (c)(2)(A), amounts are considered as paid on a patronage basis if they are paid in proportion, insofar as is practicable, to the amount of business done by or for patrons during the period to which such amounts are attributable.

In addition to the deductions allowed by subsections (c)(1) and (c)(2)(A), a deduction is allowed under subsection (c)(2)(B) for amounts paid in money or other property (except written notices of allocation) in redemption of a nonqualified written notice of allocation which was previously paid during the payment period for a taxable year on a patronage basis to a patron out of earnings derived during that taxable year either from business done for the United States or

from sources other than patronage. A deduction under subsection (c)(2)(B) will be allowed for a taxable year only for amounts paid during the payment period for that taxable year.

For purposes of the new subchapter T, a written notice of allocation is considered paid when it is issued to the patron. Amounts paid in redemption of a nonqualified written notice of allocation which are in excess of the stated dollar amount of such written notice of allocation and which in effect constitute interest may be deducted by the cooperative as interest. These excess amounts will be treated by the distributee as interest and not as a patronage dividend.

(*d*) *Payment period for each taxable year.*—Subsection (d) of section 1382 contains the definition of the "payment period for each taxable year." It provides that the payment period for any taxable year is the period beginning with the 1st day of such taxable year and ending with the 15th day of the 9th month following the close of such year. Thus, a cooperative has 8½ months after the close of a taxable year in which to pay patronage dividends out of the net earnings from patronage occurring during that taxable year. Any patronage dividend which it pays after that time must be taken into account by the cooperative in computing its taxable income; and the cooperative will be allowed no subsequent adjustment for any amount it pays in redemption of a written notice of allocation which was paid as a part of such patronage dividend. The same general rules apply with respect to nonpatronage distributions made on a patronage basis.

(*e*) *Products marketed under pooling arrangements.*—Subsection (e) of section 1382 provides a special rule for determining, for purposes of section 1382(b), when the patronage is considered to have occurred in the case of a pooling arrangement for the marketing of products. Under this rule, the patronage will (to the extent provided in regulations prescribed by the Secretary of the Treasury or his delegate) be treated as occurring during the taxable year in which the pool closes. For example, farmer A delivers to the X cooperative 100 bushels of wheat on August 15, 1963, at which time he receives a "per bushel" advance. On October 15, 1963, he receives an additional "per bushel" payment. The pool sells some of its wheat in 1963 and the rest in January of 1964. The pool is closed on February 15, 1964. For purposes of section 1382(b), A's patronage is considered as occurring in 1964.

Section 1382 has no effect on, and is not intended to change, existing rules with respect to the time at which items are taken into account in computing the cooperative's gross income. For example, a tobacco stabilization cooperative may be required by the Commodity Credit Corporation to apply a portion of its proceeds from the sale of tobacco against loans on other crop years. In a letter to the Department of Agriculture dated October 11, 1955, the Internal Revenue Service held that this portion of the proceeds was not includible in the cooperative's gross income until the cooperative had an unrestricted right to such portion. Section 1382 will in no way change this holding. Under section 1382(f), the Secretary of the Treasury or his delegate may provide by regulations that, in such a case, the patronage to which this portion of the proceeds relates is to be considered to have occurred during the taxable year when the cooperative first had an unrestricted right to such portion. This will permit the cooperative to pay these proceeds out as patronage dividends during the payment period for

such later year. If the conditions of section 1382(b) are met, such patronage dividends need not be taken into account in determining the taxable income of the cooperative for such later year. Section 1382(f) permits the Secretary of the Treasury or his delegate to provide similar rules as to when patronage is considered to have occurred in other cases when earnings are includible in the gross income of a cooperative for a taxable year after the patronage occurred.

SECTION 1383. COMPUTATION OF TAX WHERE COOPERATIVE REDEEMS NONQUALIFIED WRITTEN NOTICES OF ALLOCATION

Section 1383 provides a special rule for computing a cooperative's tax for a year when it redeems nonqualified written notices of allocation.

(*a*) *General rule.*—Section 1383(a) provides that if, for a taxable year, a cooperative is allowed a deduction under section 1382 (b)(2) or (c)(2)(B) for amounts it pays in redemption of nonqualified written notices of allocation, then its tax for that year shall be whichever of the following is the smaller:

(1) The tax for the taxable year computed with the deduction for the amounts paid in redemption of the nonqualified written notices of allocation, or

(2) An amount equal to—

(A) the tax for the taxable year computed without such deduction, minus

(B) the decrease in tax under chapter 1 for the prior taxable year (or years) which would result solely from treating such nonqualified written notices of allocation as qualified written notices of allocation.

(*b*) *Special rules.*—Section 1383(b) provides three special rules applying to the alternative tax computations based on the decrease in tax for the prior taxable years. Under section 1383(b)(1), if the decrease in tax for the prior taxable year (or years) exceeds the tax for the current year (computed without any deduction for amounts paid in redemption of nonqualified written notices of allocation), the excess is to be considered to be a payment of tax on the last day prescribed by law for the payment of tax for the current taxable year, and is to be refunded or credited in the same manner as if it were an overpayment for the current taxable year.

Section 1383(b)(2) provides that, for purposes of computing the decrease in tax for the prior taxable year, the nonqualified written notices of allocation which are treated as qualified written notices of allocation are to be considered to have a stated dollar amount equal to the amount paid in redemption of such written notices of allocation to the extent such amount is allowable as a deduction under section 1382 (b)(2) or (c)(2)(B).

Section 1383(b)(3) provides that if the alternative tax computation provided by section 1383(a)(2) is used, then the deduction otherwise allowable for the current year by reason of the redemption of nonqualified written notices of allocation is not to be allowed for any purpose under the 1954 Code.

The application of section 1383 may be illustrated by the following example:

The X Cooperative (which reports its income on a calendar year basis) pays patronage dividends of $100 in nonqualified written notices of allocation on February 1, 1964, with respect to patronage occurring in 1963. Since the patronage dividends were paid in nonqualified written notices of allocation, the X Cooperative must include the $100 in gross income and is not allowed a deduction for that amount for 1963. On December 1, 1966, the X Cooperative redeems these nonqualified written notices of allocation for $50. Section 1382(b)(2) provides that the X Cooperative is not to take that $50 into account in determining its taxable income for 1966. However, if the X Cooperative otherwise has a loss for 1966 and, therefore, owes no tax for that year, it may make the computation under the alternative method provided in section 1383(a)(2). Under this alternative, it would be permitted a credit or refund of the decrease in tax for 1963 which results from recomputing the 1963 tax liability as if patronage dividends of $50 had been paid for 1963 in qualified written notices of allocation. If this alternative is used, the X Cooperative cannot then use the $50 deduction otherwise allowable for 1966 to increase its net operating loss carryback or carryforward. If the X Cooperative also redeems on December 1, 1966, nonqualified written notices of allocation which were paid as patronage dividends on February 1, 1965, with respect to patronage occurring in 1964, it would be allowed a credit or refund for the decrease in tax for 1964. It could not, however, apply one method for computing the tax with respect to the redemption in 1966 of the nonqualified written notices of allocation paid in 1964 and the other method with respect to the redemption in 1966 of the nonqualified written notices of allocation paid in 1965.

PART II—TAX TREATMENT BY PATRONS OF PATRONAGE DIVIDENDS

Part II of subchapter T, consisting of section 1385, deals with the patron's tax treatment of patronage dividends and amounts paid by an exempt farmers' cooperative from nonpatronage earnings.

SECTION 1385. AMOUNTS INCLUDIBLE IN PATRONS GROSS INCOME

(*a*) *General rule.*—Subsection (a)(1) requires the patron to include in gross income the amount of any patronage dividend (other than one described in sec. 1385(b)) received during the taxable year from a taxable or an exempt cooperative to which part I of subchapter T applies, if paid in money, a qualified written notice of allocation, or other property (except a nonqualified written notice of allocation). Subsection (a)(2) requires inclusion in the gross income of the patron of distributions (other than those paid in nonqualified written notices of allocation) paid on a patronage basis by a farmers' cooperative exempt under section 521 with respect to earnings derived either from business done for the United States or from sources other than patronage. The patron must include patronage dividends in gross income for the taxable year during which they are received, even though the cooperative does not take them into account in computing taxable income for its preceding taxable year because they were paid during the payment period for such preceding taxable year. Patronage dividends are includible in the patron's gross income under section 1385 even if the cooperative is not permitted any adjustment for such

patronage dividends because they were not paid during the payment period for the taxable year in which the patronage occurred.

(b) *Exclusion from gross income.*—Subsection (b)(1) of section 1385 excludes from gross income a patronage dividend, or an amount received on the redemption, sale, or other disposition of a nonqualified written notice of allocation which was previously paid as a patronage dividend, which is properly taken into account as an adjustment to basis of property. For example, if a patronage dividend is attributable to the purchase of a capital asset or property used in a trade or business, such patronage dividend will not be included in the distributee's gross income but will reduce the basis of such asset or property. Subsection (b)(2) provides that a patronage dividend, or an amount received on the redemption, sale, or other disposition of a nonqualified written notice of allocation which was previously paid as a patronage dividend, which is paid to a patron with respect to the purchase of a personal, rather than a business, expense item, is not includible in gross income. These provisions are to be applied under regulations prescribed by the Secretary of the Treasury or his delegate.

(c) *Treatment of certain nonqualified written notices of allocation.*—Subsection (c)(1) of section 1385 describes the kind of nonqualified written notices of allocation to which section 1385(c) applies. This subsection applies to a nonqualified written notice of allocation which was paid as a patronage dividend by a taxable or an exempt cooperative, and to a nonqualified written notice of allocation which was paid on a patronage basis by a farmers' cooperative exempt under section 521 out of earnings derived either from business done for the United States or from sources other than patronage.

Subsection (c)(2)(A) of section 1385 provides that such a nonqualified written notice of allocation is to have a zero basis in the hands of the patron to whom it was paid. Subsection (c)(2)(B) of section 1385 provides that the basis of a nonqualified written notice of allocation described in subsection (c)(1) acquired from a decedent is to be its basis in the hands of the decedent. Any amount which the beneficiary is required to report as ordinary income on the redemption, sale, or other disposition of such written notice of allocation is income in respect of a decedent under section 691 of the code. Subsection (c)(2)(C) provides that any gain on the redemption, sale, or other disposition of a nonqualified written notice of allocation described in subsection (c)(1) is to be ordinary income to the extent that its stated dollar amount exceeds its basis. This is true whether such gain is realized by the patron who received the nonqualified written notice of allocation or any subsequent holder. For example, farmer A receives a patronage dividend paid in the form of a nonqualified written notice of allocation which is attributable to the sale of his crop to the X Cooperative. The stated dollar amount of the nonqualified written notice of allocation is $100. The basis of the written notice of allocation in the hands of farmer A is zero and he must report any amount up to $100 received by him on its redemption, sale, or other disposition as ordinary income. If farmer A gives the written notice of allocation to his son B, B takes farmer A's (the donor's) basis which is zero, and any gain up to $100 which B later realizes on its redemption, sale, or other disposition is ordinary income. Similarly, if A dies before realizing any gain on the nonqualified written notice of allocation, B, his legatee, has a zero basis for such written notice of alloca-

tion and any gain up to $100 which he then realizes on its redemption, sale, or other disposition is also ordinary income. Any amounts realized on the redemption, sale, or other disposition of such nonqualified written notice of allocation in excess of $100 will be treated under the applicable provisions of the code. These provisions in section 1385(c)(2)(C) are not intended to reflect in any way on how gain on the redemption, sale, or other disposition of a written notice of allocation would be treated under existing law.

Part III—Definitions; Special Rules

Part III of subchapter T, consisting of section 1388, defines "patronage dividend," "written notice of allocation," "qualified written notice of allocation," and "nonqualified written notice of allocation," and provides special rules for determining amounts paid or received.

SECTION 1388. DEFINITIONS; SPECIAL RULES

(*a*) *Patronage dividend.*—Under subsection (a) of section 1388, the term "patronage dividend" means an amount paid to a patron by a cooperative to which part I of subchapter T applies (1) on the basis of quantity or value of business done with or for such patron, (2) under an obligation to pay such amount, which obligation existed before the cooperative received the amount, and (3) which is determined by reference to the net earnings of the cooperative from business done with or for its patrons. It is made clear that there are not to be included as patronage dividends any amounts which are out of earnings other than from business done with or for patrons, or any amounts paid to patrons which are attributable to the patronage of other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions. Thus, if a cooperative does not pay any patronage dividends to nonmembers, any portion of the amounts paid to members which is out of net earnings from patronage with nonmembers, and which would have been paid to the nonmembers if all patrons were treated alike, is not a patronage dividend.

(*b*) *Written notice of allocation.*—The term "written notice of allocation" is defined in subsection (b) of section 1388 to mean any capital stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice, which discloses to the recipient the stated dollar amount allocated to him, and the portion thereof, if any, which constitutes a patronage dividend.

This definition is applicable both to written notices of allocation paid as patronage dividends and to written notices of allocation paid with respect to nonpatronage earnings or earnings from business done for the United States.

(*c*) *Qualified written notice of allocation.*—Subsection (c)(1) of section 1388 contains the definition of "qualified written notice of allocation". Subsection (c)(1)(A) provides, in the case of both taxable and exempt cooperatives, that the term "qualified written notice of allocation" includes a written notice of allocation which the patron may redeem in cash, at its stated dollar amount, at any time within a period beginning on the date such written notice of allocation is paid and ending not earlier than 90 days from such date. The

patron must be notified by the cooperative, in writing, at the time he receives the written notice of allocation, of this right of redemption. It is intended that this notice must be given separately to each patron and not in the form of a notice in a newspaper or posted at the cooperative's headquarters. If the patron does not exercise his option to redeem the written notice of allocation, he must, nevertheless, take it into account, at its stated dollar amount, in the manner provided in section 1385(a).

Subsection (c)(1)(B) of section 1388, also applicable to both taxable and exempt cooperatives, provides that the term "qualified written notice of allocation" also includes a written notice of allocation which the patron has consented to take into account at its stated dollar amount in the manner provided in section 1385(a). This consent must be made in the manner provided in subsection (c)(2) of section 1388.

Subsection (c)(2) of section 1388 provides the two different ways in which the consent to take written notices of allocation into account as provided in section 1385(a) may be made. The first way is to make such consent in writing. This consent must be made by the patron before the close of the cooperative's taxable year during which the patronage to which the written notice of allocation is attributable occurred. Such consent is, under subsection (c)(3)(A)(i), effective with respect to all patronage occurring during the taxable year of the cooperative in which such consent is made and, unless revoked as provided in subsection (c)(3)(B)(i), all subsequent taxable years. Subsection (c)(3)(B)(i) provides that such a consent may be revoked by the patron at any time. The revocation must be in writing and filed with the cooperative. Thus, any such written consent which is, by its terms, irrevocable is not a consent that would qualify a written notice of allocation under subsection (c)(1)(B). A revocation is only effective with respect to patronage occurring after the close of the cooperative's taxable year during which the revocation is filed with it. In the case of a patron participating in a pooling arrangement described in section 1382(e), a written consent may be made at any time before the close of the cooperative's taxable year during which the pool closes. Any subsequent revocation filed by the patron, however, would not be effective with respect to that pool.

The written consent described in the preceding paragraph is the only method by which a nonmember-patron may consent within the meaning of subsection (c)(1)(B). For a patron who is a member (or prospective member) of the cooperative, there is, however, another method by which he can consent to take written notices of allocation into account as provided in section 1385(a). In this case, the consent may be made by the patron by obtaining or retaining membership in the cooperative after—

(A) the cooperative has adopted a bylaw providing that membership in the cooperative constitutes such consent, and

(B) he has received a written notification and copy of such bylaw.

The bylaw described in (A) must be adopted by the cooperative after the date of enactment of this bill (the Revenue Act of 1962) and must contain a clear statement that membership in the coopera-

tive constitutes the prescribed consent. The following is an example of a bylaw provision which would meet this requirement:

> Each person who hereafter applies for and is accepted to membership in this cooperative and each member of this cooperative on the effective date of this bylaw who continues as a member after such date shall, by such act alone, consent that the amount of any distributions with respect to his patronage occurring after __________, which are made in written notices of allocation (as defined in 26 U.S.C. 1388) and which are received by him from the cooperative, will be taken into account by him at their stated dollar amounts in the manner provided in 26 U.S.C. 1385(a) in the taxable year in which such written notices of allocation are received by him.

Before a patron shall be considered to have consented under this second alternative, he must receive the written notification and the copy of the bylaw, as provided in (B) above. In the case of a new member, he must receive the notification and the copy of the bylaw before he becomes a member. The written notification must inform the patron that this bylaw has been adopted and of its significance. It is intended that the notification and copy of the bylaw must be given to each individual separately and not in the form of a notice in a newspaper or posted at the cooperative's headquarters.

Under subsection (c)(3)(A)(ii) of section 1388, this alternative consent will be effective with respect to all patronage of the member-patron occurring after he receives the notification and copy of the bylaw provision. In the case of a pooling arrangement described in section 1382(e), the consent will only be effective with respect to the member's actual patronage occurring after he receives the notification and copy of the bylaw and shall not be effective with respect to any of his patronage under the pool before this time. Subsection (c)(3)(B)(ii) provides that this alternative consent will not apply to any patronage of the patron after he ceases to be a member of the cooperative or after the bylaw provision is repealed by the cooperative. In the case of a pooling arrangement, this refers to the time when the patronage actually occurred. Thus, if the patron resigns his membership in the cooperative during the period a pool is in operation, he will not be considered to have consented with respect to any of his patronage under the pool after the date of his resignation.

(*d*) *Nonqualified written notice of allocation.*—Subsection (d) of section 1388 defines "nonqualified written notice of allocation" to mean a written notice of allocation which is not described in section 1388(c).

(*e*) *Determination of amount paid or received.*—Subsection (e) of section 1388 provides that, for purposes of the new subchapter T, in determining amounts paid or received: (1) Property, other than a written notice of allocation, is to be taken into account at its fair market value, and (2) a qualified written notice of allocation is to be taken into account at its stated dollar amount. Thus, if a cooperative pays a patronage dividend in qualified written notices of allocation, and the requirements of section 1382 are met, the cooperative will not be required to take the stated dollar amounts of such written notices of allocation into account in determining its taxable income. Conversely, the patron receiving a qualified written notice of allocation

must take it into account, as provided in section 1385(a), at its stated dollar amount. If a cooperative pays a patronage dividend in nonqualified written notices of allocation, it is required to include the stated dollar amount thereof in gross income and is allowed no deduction (and the patrons are not required to include such amount in gross income) at the time such written notices of allocation are paid (or received).

In determining the amount of a patronage dividend which is paid by a cooperative, there is included the amount of tax which is deducted and withheld under section 3471 (added to the 1954 Code by section 19 of this bill). The amount of tax deducted and withheld is treated as a cash distribution to the patron. For example, if Cooperative X, which pays its patronage dividends through the use of qualified written notices of allocation, determines that it will pay patron A a patronage dividend of $100 and this patronage dividend is subject to withholding at the rate of 20 percent under the new section 3471, it will issue patron A a qualified written notice of allocation with a stated dollar amount of $80 and withhold and remit $20 to the Government. In determining its taxable income, Cooperative X will, if all the conditions are met, not take $100 into account. In turn, patron A, in computing his tax liability, will take $100 into account as a patronage dividend under section 1385(a)—$80 as the stated dollar amount of the qualified written notice of allocation and $20 as a cash distribution.

SECTION 17. TAX TREATMENT OF COOPERATIVES AND PATRONS (Continued)

(*b*) *Technical amendments.*—Subsection (b) of section 17 of the bill makes certain technical amendments to reflect the provisions of the new subchapter T.

Paragraph (1) amends section 521(a) (relating to exemption of farmers' cooperatives from tax) to insert references to part I of the new subchapter T.

Paragraph (2) repeals section 522 (relating to tax on farmers' cooperatives exempt under sec. 521).

Paragraph (3) amends section 6044 to revise the provisions relating to information returns which must be filed by cooperatives. Under existing law, a cooperative must file an information return only with respect to patronage dividends which it pays. Paragraph (3) amends section 6044 to provide that a cooperative must, when required by the Secretary of the Treasury or his delegate, report on its information return (1) patronage dividends paid in cash, qualified written notices of allocation, or other property (except nonqualified written notices of allocation), (2) amounts paid in redemption of nonqualified written notices of allocation previously paid as a patronage dividend, and (3) in the case of an exempt farmers' cooperative, amounts described in section 1382(c)(2) (relating to amounts paid with respect to nonpatronage earnings). The cooperative may be required to report these amounts even though it must pay tax with respect to them because they were not paid within the prescribed time limits. Returns need only be filed, under section 6044, by organizations subject to the provisions of part I of subchapter T.

Section 6044 is also amended to remove the existing requirement that all payments of $100 or more must be reported. Under the amended section 6044 the Secretary of the Treasury or his delegate may prescribe the minimum dollar amount of payments which must be reported.

Paragraph (4) amends section 6072(d) (relating to time for filing income tax returns of exempt cooperative associations) to extend the time for filing income tax returns of certain taxable cooperatives. Under this amendment, these cooperatives need not file returns for a taxable year until the 15th day of the 9th month following the close of such taxable year. Under existing law, these nonexempt cooperatives must file returns for a taxable year on or before the 15th day of the 3d month following the close of such taxable year. The taxable cooperatives which may take advantage of this filing date provision are those described in section 1381(a)(2) which either (1) are under an obligation to pay patronage dividends in an amount equal to 50 percent or more of net earnings from business done with or for patrons, or (2) actually paid patronage dividends in such an amount out of net earnings from business done with or for patrons during the most recent taxable year for which they had such net earnings. Under existing law, exempt farmers' cooperatives are not required to file returns for a taxable year until the 15th day of the 9th month following the close of such taxable year, and this rule is not changed.

(c) *Effective dates.*—Subsection (c) of section 17 of the bill prescribes the effective dates for subsections (a) and (b).

Paragraph (1) of subsection (c) provides that, in the case of cooperatives, the amendments made by subsections (a) and (b) of the bill will, except as provided in paragraph (3), apply to taxable years of organizations described in section 1381(a) beginning after December 31, 1962.

Paragraph (2) of subsection (c) provides that, in the case of patrons, section 1385 will, except as provided in paragraph (3), apply with respect to any amount received from any organization described in section 1381(a), to the extent that such amount is paid by such organization in a taxable year of such organization beginning after December 31, 1962.

Paragraph (3) of subsection (c) provides that, in the case of any money, written notices of allocation, or other property, paid by any organization described in section 1381(a)—

(A) before the first day of the first taxable year of such organization beginning after December 31, 1962, or

(B) on or after such first day with respect to patronage occurring before such first day,

the tax treatment of such money, written notices of allocation, or other property (including the tax treatment of gain or loss on the redemption, sale, or other disposition of such written notices of allocation) by any cooperative or patron is to be made under the 1954 Code without regard to the new subchapter T. For example, if a cooperative pays a patronage dividend during its taxable year beginning January 1, 1963, out of net earnings for its taxable year ending on December 31, 1962, the tax treatment of such a patronage dividend (including the determination of when it is considered paid) would be determined under existing law. Furthermore, the provisions of section 1382 (b)(2) and (c)(2)(B) (relating to deduction for amounts

paid in redemption of certain nonqualified written notices of allocation) and section 1383 (relating to computation of tax where a cooperative redeems nonqualified written notices of allocation) are not applicable to amounts paid in redemption of a written notice of allocation which was paid (whether before or after January 1, 1963) with respect to patronage occurring before such date.

SECTION 18. INCLUSION OF FOREIGN REAL PROPERTY IN THE GROSS ESTATE

(*a*) *Amendments to include foreign real property.*—Subsection (a) of section 18 of the bill amends sections 2031(a), 2033, 2034, 2035(a), 2036(a), 2037(a), 2038(a), 2040, and 2041(a) of the 1954 Code by striking from each section the language which requires the exclusion from the gross estate of real property situated outside of the United States. The result of these amendments, subject to the effective date provisions of subsection (b) of section 18, is to include in the gross estate of decedents who are citizens or residents of the United States, the fair market value of their interest in real property which is situated outside of the United States. Under existing law real property situated outside of the United States is excluded in determining the value of the gross estate.

(*b*) *Effective date.*—Subsection (b) of section 18 provides that the amendments which repeal the exclusion for real property situated outside of the United States are effective with respect to the estates of decedents dying after the date of the enactment of the bill. However, special provisions apply in the case of decedents dying after such date of enactment and before July 1, 1964.

Under one of these provisions, the value of real property situated outside of the United States is not included in the gross estate of the decedent under section 2033, 2034, 2035(a), 2036(a), 2037(a), or 2038(a) to the extent the decedent's interest in it was acquired before February 1, 1962. Under another of these special provisions, the value of real property situated outside the United States is excluded from the gross estate of a decedent who dies after the date of the enactment of the bill and before July 1, 1964, to the extent the property or interest therein was either held by the decedent and the surviving tenant in a joint tenancy or tenancy by the entirety before February 1, 1962, or, even though the joint tenancy or tenancy by the entirety was created on or after February 1, 1962, to the extent the property or interest therein was acquired by the decedent before February 1, 1962. Under still another of these special provisions, in the case of decedents dying after the date of the enactment of the bill and before July 1, 1964, the value of real property situated outside the United States is excluded from the gross estate to the extent that before February 1, 1962, it was subject to a general power of appointment possessed by the decedent.

For purposes of applying these three special provisions, the real property, interests therein, and general powers of appointment to which these special provisions apply, which are acquired by the decedent after January 31, 1962, by gift within the meaning of section 2511, or from a prior decedent by devise or inheritance, or by reason of death, form of ownership, or other conditions (including the exercise or non-exercise of a power of appointment), are treated as acquired before

February 1, 1962, if the donor or prior decedent acquired the property, his interest therein, or a power of appointment (whether or not a general power) in respect thereof, before that date. For example, assume that A, who bought foreign real property on December 1, 1961, dies on March 1, 1962, and by will leaves the property to B who dies after the date of the enactment of the bill and before July 1, 1964. In this example B will be treated as having acquired the property before February 1, 1962, since A, the prior decedent from whom B acquired the property, had acquired it before February 1, 1962.

For purposes of the amendments made by section 18(b) of the bill, substantial capital additions and improvements to real property made after January 31, 1962, are to be treated as separate properties. Capital additions or improvements to either commercial or residential property which do not materially increase the value of the property are to be disregarded.

SECTION 19. WITHHOLDING OF INCOME TAX AT SOURCE ON INTEREST, DIVIDENDS, AND PATRONAGE DIVIDENDS

(*a*) *In general.*—Subsection (a) of section 19 of the bill amends subtitle C of the Internal Revenue Code of 1954 by redesignating chapter 25 as chapter 26 and by inserting after chapter 24 a new chapter 25, entitled "Collection of Income Tax at Source on Interest, Dividends, and Patronage Dividends." The new chapter provides a system for the withholding of tax at the source on interest, dividends, and patronage dividends. Chapter 25 consists of subchapters A, B, C, and D.

Subchapter A—Interest

SECTION 3451. INCOME TAX COLLECTED AT SOURCE ON INTEREST

(*a*) *Requirement of withholding.*—Section 3451(a) provides that, except as otherwise provided in chapter 25, every person who pays interest (as defined in sec. 3452) is to deduct and withhold on such interest a tax equal to 20 percent of the amount thereof. The person who pays interest is the person obligated on the debt out of which the interest arises. Therefore, even though remittance of interest to bondholders is made by use of an intermediary paying agent, such as a bank, the corporation obligated on the bonds is the person required to deduct and withhold tax on the interest.

The tax must be withheld at the time payment of interest is made. The term "payment" includes constructive payment. For example, A is a depositor in S Savings & Loan Co. S Company pays interest on deposits quarterly. On March 31, 1963, S Company credits the accounts of, and makes available to, its depositors the interest due for the first quarter of the year. On March 31, 1963, S Company must deduct and withhold an amount equal to 20 percent of the total amount credited to the accounts of depositors who do not have exemption certificates in effect, even though A does not present his account book to S Company to have the interest recorded until April 5, 1963.

Similarly, if the M Corporation pays interest on its outstanding coupon bonds on April 1, it is required to deduct and withhold an amount equal to 20 percent of the total interest payment on April 1

regardless of when the coupons are presented for collection. Thus, if A owns one of the bonds and presents on April 8, 1963, the coupon due on April 1, 1963, M Corporation is required to deduct and withhold the tax on April 1 and not at the time the coupon is presented by A.

However, in the case of series E United States savings bonds, withholding is not required until the bonds are surrendered or redeemed. If, pursuant to regulations prescribed under the Second Liberty Bond Act, the owner of a series E bond exchanges such obligation for another obligation issued under such act, and gain or loss is not recognized because of the provisions of section 1037 (or so much of sec. 1031 as relates to sec. 1037), withholding on the increment on the series E bond is not required until the obligation received in exchange is surrendered or redeemed. If the property received in the exchange consists not only of property permitted to be received without the recognition of gain but also of other property or money, then withholding is required at the time of the exchange to the extent of 20 percent of the gain recognized.

(*b*) *Payee unknown.*—Section 3451(b) provides that if the withholding agent is unable to determine the person to whom interest is payable, the tax is to be deducted and withheld at the time payment thereof would be made if such person were known. Thus, if a withholding agent is unable to ascertain the identity of the owner of certain bonds in respect of which interest is payable, or is unable to determine the true owner of bonds due to the existence of conflicting claims to such bonds asserted by two or more persons, the withholding agent is nevertheless required to deduct and withhold the tax on the amount of the interest payable in respect of such bonds at the time payment would have been made if the owner were known.

SECTION 3452. INTEREST DEFINED

(*a*) *General rule.*—Section 3452(a) defines the term "interest" as used in chapter 25 to mean:

(1) Interest (A) on evidences of indebtedness (including bonds, debentures, notes, and certificates) issued by a corporation with interest coupons or in registered form, and (B) to the extent provided in regulations prescribed by the Secretary of the Treasury or his delegate, on other evidences of indebtedness issued by a corporation of a type offered by corporations to the public. For this purpose, an instrument is in registered form if its transfer must be effected by the surrender of the old instrument and either the reissuance of the old instrument by the corporation to the new holder or the issuance by the corporation of a new instrument to the new holder. If an instrument can be transferred by endorsement it is not in registered form even though a list is maintained by the corporation of the negotiable instruments issued by it. Therefore, an evidence of indebtedness issued by a corporation falls into category (A) if it either is nonnegotiable or, if negotiable, was issued with interest coupons.

To the extent provided in regulations prescribed by the Secretary of the Treasury or his delegate, interest on negotiable instruments issued by corporations without interest coupons (*i.e.*, evidences of indebtedness which do not fall into category (A)) will constitute interest on evidences of indebtedness falling into category (B) and subject to withholding under section 3451 if the instruments are of a

type offered by corporations to the public. However, it is not expected that the Secretary of the Treasury or his delegate will extend withholding to interest on instruments described in category (B) unless he is able to describe the instruments with such definiteness that both the issuers and holders thereof will encounter no difficulty in determining whether the interest is subject to withholding.

As used in section 3452(a)(1), the term "of a type offered by corporations to the public" refers to a type of instrument. In determining whether a particular instrument comes within the scope of the term it is immaterial whether the particular instrument (or any instrument of the issue of which it is a part) actually was offered to the public so long as it is of a type which is offered by corporations to the public. Therefore, in a case where an entire issue is offered by a corporation only to its shareholders, the instruments come within the scope of the term if they are of a type offered by corporations to the public. The term does not have reference to instruments of a type offered by corporations only to other corporations.

(2) Interest on deposits with persons carrying on the banking business. This paragraph includes interest payments by any individual or organization carrying on the banking business.

(3) Amounts (whether or not designated as interest) paid by a mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, or similar organization, in respect of deposits, investment certificates, or withdrawable or repurchasable shares.

(4) Interest on amounts held by an insurance company under an agreement to pay interest thereon. This paragraph includes interest paid with respect to dividends held by an insurance company, and interest on the proceeds of an insurance policy held by an insurer under an agreement to pay interest thereon. This paragraph does not apply to amounts which represent the so-called "interest element" in the case of annuity or installment payments under a life insurance or endowment contract.

(5) Interest on deposits with stockbrokers.

(6) Interest on obligations of the United States, including interest paid on postal savings certificates of deposit regardless of when the deposits were made.

(7) In the case of a non-interest-bearing obligation of the United States issued on a discount basis, and having a maturity date more than 1 year from the date of issue, the amount by which the amount paid on surrender or redemption exceeds the issue price. For example, the increment earned on series E United States savings bonds is subject to withholding when the bonds are surrendered or redeemed.

Generally, interest paid by individuals is not included within the definition of interest on which withholding is required. For example, A, an individual, makes installment payments upon the contract price of a washing machine purchased from M Company. No withholding is required on the amount of the installment payment which constitutes interest. Similarly no withholding is required on interest paid by one individual to another individual in connection with a loan. However, if B, an individual who is a stockbroker, retains sums of money belonging to C, a client, and pays interest thereon, B is required to deduct and withhold 20 percent of the amount of interest paid.

Except in the case of those United States obligations described in section 3452(a)(7), for purposes of chapter 25 discount is not treated as interest and there is no withholding on the amount of such discount.

(*b*) *Exceptions.*—Subsection (b) of section 3452 provides that for purposes of chapter 25 the term "interest" does not include:

(1) Interest on obligations described in section 103(a) (1) or (3) (relating to obligations of a State, etc.).

(2) Any amount paid by (A) a foreign government or international organization; (B) a foreign corporation not engaged in trade or business within the United States; (C) a nonresident alien individual not engaged in trade or business within the United States; or (D) a partnership not engaged in trade or business within the United States and composed in whole or in part of nonresident aliens. The term "international organization" means an organization defined as such under section 7701(a)(18) of the 1954 Code.

(3) Interest on deposits with persons carrying on the banking business paid to (A) a foreign corporation not engaged in trade or business within the United States; (B) a nonresident alien individual not engaged in trade or business within the United States; or (C) a partnership not engaged in trade or business within the United States and composed in whole or in part of nonresident aliens.

(4) Any amount paid by one corporation to another corporation, if both are members of the same affiliated group which filed a consolidated return under chapter 6 of the 1954 Code for the preceding taxable year of the affiliated group. In determining whether both corporations are members of the same affiliated group at the time the amount is paid, the rules provided under chapter 6 of the 1954 Code (relating to consolidated returns of income tax) will govern.

(5) Interest subject to withholding under section 1441 or 1442 by the person paying such interest or which would be so subject to withholding but for the fact that it is not treated as income from sources within the United States. Under this paragraph, if a person is required to withhold under section 1441 or 1442 (including a person required to withhold under such section by reason of sec. 1444(a)) on interest by reason of it being paid to a person who is a nonresident alien individual, a partnership not engaged in trade or business within the United States and composed in whole or in part of nonresident aliens, or a foreign corporation not engaged in trade or business within the United States, such person is not required to withhold on such interest under chapter 25.

(6) Any amount on which the withholding agent is required to deduct and withhold a tax under section 1451 (relating to tax-free covenant bonds), or would be so required but for section 1451(d) (relating to benefit of personal exemptions). Thus, the payment of interest on a tax-free covenant bond issued before January 1, 1934, is not subject to withholding under chapter 25. The fact that the person entitled to receive such interest files with the withholding agent a signed notice in writing, as provided in section 1451(d) of the 1954 Code, claiming the benefit of the deduction for personal exemptions provided in section 151 of the code, thereby relieving the withholding agent of any duty to withhold a tax under section 1451(a), does not abrogate the exemption provided in this paragraph.

(7) To the extent provided in regulations prescribed by the Secretary of the Treasury or his delegate, any amount payable with respect

to deposits in school savings accounts. It is expected that this exemption will apply to interest on deposits made by students of an elementary or secondary school under a program participated in by the school for the purpose of teaching thrift.

(8) Any of the following amounts if paid to a State, a foreign government, or an international organization: (A) Interest on deposits with persons carrying on the banking business; (B) amounts (whether or not designated as interest) paid by a mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, or similar organization, in respect of deposits or nontransferable certificates or shares; or (C) in the case of a non-interest-bearing obligation of the United States issued on a discount basis, and having a maturity date more than 1 year from the date of issue, the amount by which the amount paid on surrender or redemption exceeds the issue price. In order for payors to effect an exemption for these amounts it is contemplated that they will require a statement from the payee identifying itself as a State, foreign government, or international organization.

(c) *Exemption for United States.*—Subsection (c) of section 3452 provides that the Secretary of the Treasury may authorize exemption from withholding on interest paid by the United States or any wholly owned agency or instrumentality thereof to the United States or any wholly owned agency or instrumentality thereof if withholding on the interest will cause a burden or expense which can be avoided by granting the exemption. For example, the Secretary of the Treasury can exempt from withholding interest paid by the United States on obligations held by the Federal old-age and survivors insurance trust fund.

Subchapter B—Dividends

SECTION 3461. INCOME TAX COLLECTED AT SOURCE ON DIVIDENDS.

(a) *Requirement of withholding.*—Section 3461(a) provides that, except as otherwise provided in chapter 25, every person who pays a dividend is to deduct and withhold on such dividend a tax equal to 20 percent of the amount thereof. The person who pays a dividend (as defined in sec. 3462(a)(1)) is the corporation upon whose stock the dividend is being paid. Therefore, even though remittance of the dividend to the shareholders is accomplished by the use of a disbursing agent, the corporation upon whose stock the dividend is paid remains the person paying the dividend and, consequently, the person required to deduct and withhold tax on the dividend. For example, the M Corporation on June 1, 1963, pays a dividend (through a disbursing agent) of 60 cents per share to its stockholders. A, an individual, owns 100 shares of M stock. The total amount of the dividend payable to A is $60. The M Corporation is required to deduct and withhold the sum of $12. If the total dividend paid and subject to withholding amounted to $1,200,000, the corporation would remit to the Internal Revenue Service 20 percent of the total, or $240,000.

The tax must be withheld at the time payment of a dividend is made. The term "payment" includes constructive payment, as was previously explained with reference to the payment of interest.

(b) *Payee unknown.*—Section 3461(b) provides that, if the withholding agent is unable to determine the person to whom the dividend

is payable, the tax is to be deducted and withheld at the time payment of the dividend would be made if such person were known. The explanation given above with respect to the comparable provision in section 3451, relating to interest, is equally applicable with reference to dividends.

(*c*) *Amount of dividend unknown.*—Section 3461(c) provides that if the withholding agent is unable to determine the portion of a distribution which is a dividend the tax required to be deducted and withheld under this section is to be computed on the entire amount of the distribution. Thus, the total amount of a distribution made by a regulated investment company, which includes gains realized on the sale or exchange of property, must be withheld upon if at the time such distribution is made the withholding agent is unable to determine the portion of the distribution which is a dividend.

SECTION 3462. DIVIDEND DEFINED

(*a*) *General rule.*—Section 3462(a) defines the term "dividend" as used in chapter 25 to mean: (1) Any distribution by a corporation which is a dividend as defined in section 316; and (2) any payment made by a stockbroker to any person as a substitute for a dividend (as so defined). Withholding is applicable to a dividend whether it is paid in cash or in property. A dividend paid by an insurance company to a policyholder, other than a dividend upon the capital stock of such insurance company, is not a dividend within the meaning of section 3462(a). Certain distributions which are dividends under the foregoing definition are exempt from the requirement of withholding under chapter 25. These exemptions are discussed below.

(*b*) *Exceptions.*—Section 3462(b) provides that, for purposes of chapter 25, the term "dividend" does not include:

(1) Any amount paid in the stock, or rights to acquire the stock, of the distributing corporation, if the distribution is not includible in the gross income of the recipient under the provisions of section 305 of the 1954 Code (relating to distributions of stock and stock rights).

(2) Distributions to shareholders which are treated for income tax purposes as amounts received on the sale or exchange of property, or distributions with respect to which gain or loss is not recognized to the shareholders. Capital gain dividends distributed by regulated investment companies or real estate investment trusts are within this exception.

In addition, tax is not required to be withheld on distributions subject to section 331 of the 1954 Code, relating to amounts distributed in complete or partial liquidation of a corporation. Also, a distribution which is made without the recognition of gain or loss under the provisions of section 355 (relating to distributions of stock and securities of a controlled corporation) is not subject to withholding.

(3) Any amount which is includible in gross income as a taxable dividend by reason of the provisions of section 302 (relating to redemptions of stock), section 306 (relating to disposition of certain stock), section 356 (relating to receipt of additional consideration in connection with certain reorganizations), or section 1081(e)(2) (relating to certain distributions pursuant to order of the Securities and Exchange Commission). Section 1081(e)(2) provides that, in the case of certain

exchanges not solely in kind, gain realized by the taxpayer may be taxed as a dividend.

(4) Any amount paid by a corporation to another corporation, if both corporations are members of the same affiliated group which filed a consolidated return under chapter 6 of the 1954 Code for the preceding taxable year of the affiliated group. In determining whether both corporations are members of the same affiliated group at the time the amount is paid, the rules provided under chapter 6 of the 1954 Code (relating to consolidated returns of income tax) will govern.

(5) Any amount which (A) is subject to withholding under section 1441 or 1442 (including an amount required to be withheld upon under such section by reason of sec. 1444(a)) by the person paying the amount, or (B) would be subject to withholding under section 1441 or 1442 by the person paying the amount but for the fact that it is attributable to income from sources outside the United States, or for the fact that the payor thereof is excepted from the application of section 1441(a) by the provisions of section 1441(c). Under this paragraph, if a corporation pays a dividend to a person who is a nonresident alien individual, a partnership not engaged in trade or business within the United States and composed in whole or in part of nonresident aliens, or a foreign corporation not engaged in trade or business within the United States, withholding will not be required under chapter 25.

(6) Any amount paid by a foreign corporation not engaged in trade or business within the United States.

(7) Amounts treated under section 1373 as amounts distributed as dividends. Thus, amounts of the undistributed taxable income of an electing small business corporation which a shareholder of such corporation must include in his gross income are not subject to withholding under the provisions of chapter 25. Amounts actually distributed by such a corporation to its shareholders are subject to the requirement of withholding if they are included within the definition of dividends contained in chapter 25.

(8) Amounts paid pursuant to the terms of a lease entered into before January 1, 1954, if under such lease the shareholders of the lessor corporation are entitled to such amounts without deduction for any tax which any law of the United States might require to be deducted and withheld on the payment of dividends. This exception is applicable to amounts paid under any lease entered into before January 1, 1954, if the lessee corporation has agreed to reimburse the shareholders of the lessor corporation for any tax required to be deducted and withheld upon the payment of dividends to them.

Subchapter C—Patronage Dividends

SECTION 3471. INCOME TAX COLLECTED AT SOURCE ON PATRONAGE DIVIDENDS

(*a*) *Requirement of withholding.*—Section 3471(a) provides that every cooperative which is governed by part I of subchapter T of chapter 1 of the code (added by sec. 17 of the bill) must withhold 20 percent of certain amounts which it pays to its patrons. The

withholding tax imposed by section 3471(a) applies to amounts described in section 3472.

(*b*) *Payee unknown.*—Section 3471(b) is similar to sections 3451(b) and 3461(b), and provides that if the withholding agent is unable to determine the person to whom the amount described in section 3472 is payable, he nevertheless is required to withhold at the time payment would be made if the person were known.

SECTION 3472. AMOUNTS SUBJECT TO WITHHOLDING

(*a*) *General rule.*—Section 3472(a) provides that the amounts subject to withholding under section 3471 are—

(1) the amount of any patronage dividend (as defined in sec. 1388(a)) which is paid in money, qualified written notices of allocation (as defined in sec. 1388(c)), or other property (except nonqualified written notices of allocation as defined in sec. 1388 (d)); and

(2) any amount described in section 1382(c)(2)(A) (relating to certain nonpatronage distributions) which is paid in money, qualified written notices of allocation, or other property (except nonqualified written notices of allocation) by an exempt farmers' cooperative described in section 521.

There is no withholding on amounts paid by a cooperative in nonqualified written notices of allocation or in redemption of nonqualified written notices of allocation.

(*b*) *Exceptions.*—Section 3472(b) lists the exceptions to the general rule. Paragraph (1) is similar to sections 3452(b)(4) and 3462(b)(4) and provides that amounts paid by one corporation to another are not subject to withholding if both corporations are members of the same affiliated group and a consolidated return was filed by such group for the preceding taxable year. Paragraph (2) is similar to sections 3452(b)(5) and 3462(b)(5) and provides that amounts subject to withholding by the cooperative under section 1441 or 1442 are not subject to withholding under section 3471. Also excepted under paragraph (2) are amounts which otherwise would be subject to withholding by the cooperative under section 1441 or 1442, but for the fact that they are not treated as income from sources within the United States. Paragraph (3) is similar to sections 3452(b)(2)(B) and 3462(b)(6) and provides that amounts paid by a foreign corporation not engaged in trade or business within the United States are not subject to the provisions of section 3471.

(*c*) *Exemptions for certain consumer cooperatives.*—Since patronage dividends attributable to the purchase of personal, living, or family items are not includible in the patron's gross income, section 3472(c) provides that any cooperative which the Secretary of the Treasury or his delegate determines to be primarily engaged in selling at retail goods or services of a type that are generally for personal, living, or family use shall be granted exemption from the withholding tax imposed by section 3471. For this exemption to apply, the cooperative must file an application with the Secretary of the Treasury or his delegate in accordance with regulations to be prescribed.

(*d*) *Determination of amount paid.*—Section 3472(d) provides that, in determining amounts paid, property other than a written notice of allocation is to be taken into account at its fair market value, and

qualified written notices of allocation are to be taken into account at their stated dollar amount. This treatment is consistent with that accorded under subchapter T of chapter 1. Thus, in determining the amount which must be deducted and withheld on a patronage dividend, the portion of the dividend paid in qualified written notices of allocation must be valued at the stated dollar amount of the written notices of allocation. For example, if a cooperative pays a patronage dividend of $100, it can pay that dividend by a written notice of allocation with a stated dollar value of $80; the remaining $20 must be deducted and withheld by the cooperative and will be considered a patronage dividend paid in cash. No amount is required to be deducted and withheld on any amount of a patronage dividend paid in nonqualified written notices of allocation.

Subchapter D—General Provisions

SECTION 3481. LIABILITY FOR RETURN AND PAYMENT OF WITHHELD TAX

(*a*) *General rule.*—Section 3481(a) provides that every person who is required to deduct and withhold tax under section 3451, 3461, or 3471 is to make a return of the tax required to be deducted and withheld by him during each quarter of his taxable year. The return must be filed and the tax must be paid to the officer designated in section 6151 (relating to time and place for paying tax shown on returns) on or before the last day of the first month following the close of the quarter of the taxable year during which it was deducted and withheld. Under the provisions of section 3481(a) a withholding agent is made liable for payment of the taxes required to be deducted and withheld on interest, dividends, and patronage dividends. A withholding agent's obligations will be satisfied by computing his tax by taking 20 percent of the total amount of dividends, interest, and patronage dividends on which he is required to deduct and withhold and which are paid within the period covered by the return, by filing the return, and by paying to the Government the amount so computed. He will not thereafter be liable to any person for the amount so deducted and withheld and paid to the Government.

(*b*) *Tax paid by recipient.*—In any case where, for whatever reason, a withholding agent fails to deduct and withhold the tax required by chapter 25 and the recipient of the interest, dividend, or patronage dividend actually pays the income tax he owes on such payment, the withholding agent is relieved of liability for payment of the tax which he failed to deduct and withhold. However, payment of the tax by the recipient does not relieve the withholding agent of liability for any penalties or additions to the tax otherwise applicable in respect of his failure to deduct and withhold the tax.

SECTION 3482. RETURN AND PAYMENT BY UNITED STATES

Under the provisions of section 3482 if the person required to file a return and pay the tax under the provisions of section 3481 is the United States or any wholly owned agency or instrumentality thereof, the return of the tax deducted and withheld may be made either by the officer or employee having control of the payment of the amount

subject to withholding, or by an officer or employee appropriately designated for that purpose.

SECTION 3483. EXEMPTION CERTIFICATES

(*a*) *General rules.*—Section 3483(a) provides for an exemption from withholding under chapter 25 on certain amounts paid to certain persons who file exemption certificates with the withholding agent.

The amounts which may be exempted from withholding under section 3483(a) in the case of individuals are all amounts subject to withholding under chapter 25 except (A) amounts described in section 3452(a)(1), relating to interest on evidences of indebtedness issued by corporations, (B) amounts described in section 3452(a)(3) which are paid in respect of a transferable certificate or share, and (C) amounts described in section 3452(a)(6), relating to interest on certain obligations of the United States.

Under the provisions of subsection (a)(1), any individual under age 18 who wishes to claim the exemption may do so by filing with any withholding agent, who pays amounts described above, an exemption certificate on which he certifies the date of his birth. If such a certificate is filed, all amounts described above which are payable by the withholding agent to the individual, on and after the effective date for the certificate and before the beginning of the calendar year during which the certificate indicates that the individual will attain the age of 18, are to be exempt from withholding under chapter 25. It is contemplated that the regulations will permit the individual to revoke such a certificate.

Exemption certificates are not required with respect to interest paid on school savings accounts which are excepted from withholding by section 3452(b)(7).

Under the provisions of subsection (a)(2), any individual who is over age 17 at the beginning of a calendar year may claim an exemption by filing with any withholding agent, who pays amounts described above, an exemption certificate on which he certifies that he will have attained the age of 18 before the close of the calendar year for which such certificate is filed and that he reasonably believes that he will not (after the application of the credits against tax provided by pt. IV of subch. A of ch. 1, other than the credits under secs. 31 and 39) be liable for the payment of any tax under chapter 1 for each of his taxable years any portion of which is included in the period for which such certificate will be in effect. Thus, an individual over age 17 who would be liable for payment of income tax for his taxable year except for the fact that tax was withheld on his wages, or on interest, dividends, or patronage dividends received by him, is not eligible for exemption under section 3483. If the taxable year of an individual over 17 is other than a calendar year, he must be able to make the certification as to nonliability for tax with respect to each taxable year any portion of which is included in the period for which the exemption certificate is effective. An individual who expects to file a joint return for any taxable year a part or all of which is included in the effective period of an exemption certificate must be able to certify that there will be no tax liability on such joint return. If a certificate is filed under the provisions of section 3483(a)(2), all amounts described above which are payable by the withholding agent to the individual

during the period the certificate is in effect are to be exempt from withholding under chapter 25. Except as the Secretary of the Treasury or his delegate may otherwise provide in regulations, an exemption certificate filed by an individual over age 17 will remain in effect only for the period beginning on the effective date of the certificate and ending at the close of the calendar year in which such period begins. It is expected that, if the Secretary or his delegate finds that certain individuals, such as those over age 65, generally remain in a nontaxable status, he may provide by regulations a procedure permitting exemption certificates filed by such individuals to remain effective for more than a year. The individual would, however, be required to revoke the certificate if he becomes taxable.

Under the provisions of section 3483(a)(3), an organization (other than a cooperative described in sec. 521) which is exempt from the tax imposed by chapter 1 may claim exemption from withholding on certain amounts. The amounts which may be exempted from withholding under this subsection are those amounts described in section 3452(a)(2) (relating to interest on deposits with persons carrying on the banking business), section 3452(a)(3) (relating to amounts paid by mutual savings banks, savings and loan associations, building and loan associations, etc., in respect of deposits, investment certificates, or withdrawable or repurchasable shares), and section 3452(a)(7) (relating to increment in value of series E savings bonds, etc.). A tax-exempt organization may claim the exemption by filing with any withholding agent who pays any of these amounts an exemption certificate on which it certifies that it is such an organization. If such a certificate is filed, all amounts described above which are payable by the withholding agent to the organization on and after the effective date for the certificate will (except as provided in sec. 3483 (a)(3)(B)) be exempt from the requirement of withholding under chapter 25. Section 3483(a)(3)(B) provides that an exemption certificate filed by a tax-exempt organization will cease to be effective on the 30th day after the day on which the withholding agent with whom the certificate was filed is notified by either the organization or the Secretary of the Treasury or his delegate that the organization is no longer exempt from the tax imposed by chapter 1. If an organization ceases to be an organization which is exempt from the tax imposed by chapter 1, it must, within the time specified in regulations prescribed by the Secretary of the Treasury or his delegate, so notify each withholding agent with whom it has an exemption certificate in effect.

In general, a person entitled to exemption need file only one exemption certificate with any withholding agent. Thus, an individual who has two savings accounts in the same bank need file only one exemption certificate to exempt the interest on both accounts from withholding.

Withholding agents are required to honor an exemption certificate which on its face indicates that the person filing it is entitled to exemption, regardless of whether such person is in fact entitled to file it. Penalties for willfully filing a false and fraudulent certificate under section 3483 are provided in section 7205.

(*b*) *Exceptions and special rules.*—Subsection (b) of section 3483 provides exceptions and special rules governing the application of subsection (a). Paragraph (1) of subsection (b) provides that section 3483 is not to apply to any amount described in section 3452(a)(1),

section 3452(a)(3) paid in respect of a transferable certificate or share, or section 3452(a)(6). Thus, an exemption certificate filed with a savings and loan association does not apply with respect to interest paid on an investment certificate which is transferable. Paragraph (2) of subsection (b) provides that a separate certificate is to be filed in the case of each transaction involving the redemption of one or more obligations described in section 3452(a)(7) (relating to certain obligations of the United States issued on a discount basis, such as series E bonds). Paragraph (3) provides that the Secretary of the Treasury or his delegate may by regulation extend the exemption provided by section 3483 to amounts (other than dividends as defined in sec. 3462(a)) paid through nominees, amounts paid to custodians, and amounts paid jointly to two or more individuals. Thus, the exemption may not be extended to dividends paid on stock held in a street name.

Paragraph (4) provides that any exemption certificate under section 3483 will take effect on such day as is specified in accordance with regulations prescribed by the Secretary of the Treasury or his delegate. Paragraph (5) provides that exemption certificates under section 3483, and notices under section 3483(a)(3)(B), are to be in such form and contain such information as the Secretary of the Treasury or his delegate may prescribe by regulations.

A person who is entitled to file exemption certificates under section 3483 need not do so, but may file a claim for refund under the applicable provisions of section 3484 or 3485. A credit or refund of the tax deducted and withheld with respect to amounts for which no exemption from withholding is provided under section 3483 may be obtained under section 39 or 3484 in the case of an individual, or under section 39, 3485, or 3505 in the case of a tax-exempt organization.

SECTION 3484. REFUND OF TAX TO INDIVIDUALS

Section 3484 provides for refunds during the year, to certain individuals, of the tax deducted and withheld on interest, dividends, and patronage dividends received by them during the first three quarters of the taxable year. The amount refundable to an individual may not exceed his refund allowance which is determined in the manner provided in subsection (b). In general, a married couple which expects to file a joint income tax return for the taxable year is treated as one individual for purposes of obtaining a refund under section 3484.

(*a*) *General rule.*—Subsection (a) of section 3484 provides for a prompt refund (as an overpayment of tax) of the tax deducted and withheld under chapter 25 on amounts received by an individual during any quarter of his taxable year (other than the fourth quarter) to the extent such tax does not exceed his refund allowance at the time the claim is filed. The claim for refund filed during any quarter of the individual's taxable year may also include the tax withheld on amounts received by him during any prior quarter of the same taxable year if no allowable claim for refund has been filed under section 3484 with respect to such tax. No claim for refund may be filed under section 3484 with respect to tax withheld on amounts received during the fourth quarter of an individual's taxable year. Any tax withheld with respect to amounts received during the fourth quarter, together with tax withheld on amounts received during the first three quarters of such year for which no allowable claim for refund has been

filed under section 3484, may be claimed as a credit under section 39 against the tax imposed by chapter 1. A refund of tax is to be made under section 3484 only if the amount claimed and allowable equals or exceeds $10.

(*b*) *Refund allowance.*—Subsection (b) of section 3484 provides that, for purposes of section 3484, the refund allowance of an individual as of the time a claim for refund is filed is an amount equal to the excess, if any, of—

(1) 22 percent of—

(A) the amounts of the deductions which, on the basis of facts existing at the time the claim for refund is filed, such individual would be allowed for the taxable year under section 151 (relating to deductions for personal exemptions), plus

(B) if the individual, at the time the claim for refund is filed, reasonably expects that he will be allowed a credit under section 37 for the taxable year, the amount which, at such time, such individual reasonably expects to be the amount of his retirement income (as defined in sec. 37(c) and as limited by sec. 37(d)) for the taxable year, less

(C) the amounts (other than amounts on which tax is required to be deducted and withheld under ch. 25) which, at the time the claim for refund is filed, such individual reasonably expects to be includible in his gross income for the taxable year; over

(2) the amounts of tax with respect to which an allowable claim for refund has been previously filed under section 3484 during the taxable year.

For purposes of paragraph (1)(C) of subsection (b), an individual who files a second, third, or fourth claim for refund under section 3484 for any taxable year may use the estimate for the preceding claim unless he reasonably expects the amounts referred to in subparagraph (C) to exceed such prior estimate by more than $100. Thus, an individual who, at the time he files his second claim, reasonably expects that he will receive for the year $150 more in wages than he estimated at the time he filed his first claim, must recompute his refund allowance on his second claim.

(*c*) *Married individuals.*—Subsection (c) of section 3484 provides that, for purposes of subsections (a), (b), and (d), married individuals are to be treated as one individual if, at the time the claim for refund is filed, they reasonably expect that they will file a joint return for the taxable year in which the claim is filed. If a husband and wife reasonably expect at the time a claim for refund is filed that they will file a joint income tax return for their current taxable year, they must compute a single refund allowance taking into account both the husband's and wife's income not subject to withholding under chapter 25, as well as the other factors on which the allowance is based. In such a case, they must file a joint claim and the single refund allowance will be the maximum amount which may be refunded with respect to tax withheld on both the husband and the wife.

(*d*) *Time for filing claim.*—Subsection (d) of section 3484 provides that not more than one claim may be filed under section 3484 by any individual during any quarter of his taxable year. The claim may be filed at any time during the quarter. A refund of tax deducted and

withheld on amounts received during a taxable year is to be made under this section only if claim therefor is filed on or before the last day of such taxable year. A claim filed during the first three quarters may include the tax withheld on amounts received during the quarter in which the claim is filed or during any prior quarter if no allowable claim for refund has been filed under section 3484 for such tax. Although no claim may be filed under section 3484 with respect to tax deducted and withheld on amounts received during the fourth quarter of an individual's taxable year, a claim may be filed during the fourth quarter with respect to tax withheld on amounts received during prior quarters to the extent not previously claimed. No claim may cover tax on amounts not yet received.

The claim for refund filed by an individual for the first quarter of his taxable year will contain a computation of his refund allowance, made in the manner provided in section 3484(b). Upon receipt of the claim, the Internal Revenue Service will establish a refund account for the individual. The Internal Revenue Service will mail to the individual a refund claim form for the second quarter, which will show the maximum amount which may be refunded to him based upon his refund allowance as computed by the Service from the facts stated on his first claim. If there are no changes requiring a recomputation of his refund allowance, the individual will so certify on the claim form and will specify the net amounts of interest, dividends, and patronage dividends, on which tax has been withheld under chapter 25, which he has received and which were not included on his prior claim. When the claim, properly signed, is returned to the Internal Revenue Service it will constitute his claim for refund of the tax withheld with respect to the net amounts specified and, to the extent that the amount of such tax does not exceed the individual's refund allowance, it will be promptly refunded to him. If the facts on which his refund allowance computation is based have changed, the individual must recompute his refund allowance on the form provided on the back of the claim. The amount of his refund may not exceed the amount of the new refund allowance thus determined. An individual is not required to recompute his refund allowance because of a change in his estimate of amounts (other than amounts on which tax is required to be deducted and withheld under ch. 25) which he reasonably expects to be includible in his gross income for the taxable year, unless his new estimate exceeds the prior estimate by more than $100. If an individual chooses, he need not wait until he receives the claim form from the Internal Revenue Service, but may file a claim for refund under this section at any time during the quarter. If he does so, he may not file another claim during that quarter.

Procedures similar to those described in the preceding paragraph will be followed by the Internal Revenue Service and the individual for the third quarter.

It is anticipated that at the close of the year, the Internal Revenue Service will mail to each individual who files claims for refund under the above procedure a statement showing the total amount of refunds made to him during the year.

(*e*) *Individuals not eligible for refund.*—Subsection (e) of section 3484 provides that no claim for refund may be filed under this section by—

(1) any individual (other than an individual referred to in par. (2) or (3) of such subsec. (e)) unless, at the time the claim for refund is filed, he reasonably expects that his gross income for the taxable year will not exceed $5,000;

(2) any married individual unless, at the time the claim for refund is filed, he reasonably expects that the aggregate of his gross income and that of his spouse for the taxable year will not exceed $10,000;

(3) a head of a household (as defined in sec. 1(b)(2)) or a surviving spouse (as defined in sec. 2(b)) unless, at the time the claim for refund is filed, he reasonably expects that his gross income for the taxable year will not exceed $10,000; or

(4) any child, unless, at the time the claim for refund is filed, he reasonably expects that no deduction would be allowed for him under section 151(e)(1)(B) for the taxable year of his parent (or parents) beginning with or within the calendar year in which the claim for refund is filed.

The application of section 3484 may be illustrated by the following example:

H and W, married individuals both over 65 and under 72, receive dividends of $350 on January 1, April 1, July 1, and October 1, and interest of $600 on April 1 and October 1. The interest is received by W and the dividends by H. H and W each expect to have $1,000 of wages during the year. H and W expect to file a joint return for their taxable year ending on December 31, and will be allowed four exemptions.

(1) Allowance for exemptions (4×$600)	$2, 400
(2) Reasonable estimate of retirement income	2, 400
(3) Total, (1) and (2)	4, 800
(4) Less: Wages	2, 000
(5) Balance ((3) minus (4))	2, 800
(6) 22 percent of line (5)	616

	1st quarter	2d quarter	3d quarter
(*a*) Amount withheld, 20 percent	$70	$190	$70
(*b*) Line (6)	616	616	616
(*c*) Refund for prior quarters		70	260
(*d*) Refund allowance ((*b*)−(*c*))	616	546	356
(*e*) Refund (smaller of (*a*) or (*d*))	70	190	70

The $190 of tax deducted and withheld on the interest and dividends received on October 1 may be claimed as a credit under section 39 on H and W's joint income tax return for the year.

SECTION 3485. REFUND OF TAX TO STATES, TAX-EXEMPT ORGANIZATIONS, ETC.

Section 3485 provides that in the case of a person which is the United States, a State, a foreign government or international organization, an organization (other than a cooperative described in sec. 521) exempt from the income tax, or a foreign central bank of issue, if the amount withheld as tax with respect to dividends, interest, or patron-

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age dividends received during any calendar quarter exceeds the credit, if any, claimed by and allowable to such person for that quarter under section 3505, which is added to the 1954 Code by subsection (d)(1) of section 19 of the bill, the excess (together with any such excess for any prior quarter of the same calendar year with respect to which no refund has been claimed and allowed under sec. 3485) is to be promptly refunded or credited to such person as an overpayment of the tax imposed by chapter 25. (For provisions excluding from withholding certain amounts paid to persons described in sec. 3485, see sec. 3452(b)(8) (relating to States, foreign governments, and international organizations), sec. 3452(c) (relating to the United States), and sec. 3483(a)(3) (relating to tax-exempt organizations).) The term "an organization (other than a cooperative described in sec. 521) exempt from the tax imposed by chapter 1" does not include a taxpayer merely because its deductions exceed its gross income.

Any person entitled under this section to claim a refund of tax withheld upon dividends, interest, or patronage dividends paid to it may file the claim immediately after the close of the calendar quarter in which they were received by it. The term "received" as used in this section includes constructive receipt. Therefore, in any case where a person exempt from income taxation constructively receives interest in any calendar quarter, the tax withheld upon that interest may be included in the claim filed for that quarter, even though the interest may not actually be collected until a subsequent quarter. A claim for refund under this section need not be filed for each calendar quarter in which dividends, interest, or patronage dividends are received. Thus, one claim may cover tax withheld on amounts received during more than one quarter. However, no claim in respect of tax withheld upon dividends, interest, or patronage dividends may be filed before the close of the calendar quarter in which such amounts are received.

If the person claiming a refund under this section for a calendar quarter also claims a credit under section 3505 for the same calendar quarter and the credit is allowable, the amount which may be refunded under section 3485 with respect to that quarter may not exceed the tax withheld with respect to dividends, interest, or patronage dividends received during that quarter, less the amount of such credit which is allowable under section 3505. However, the credit allowable under section 3505 is not required to be claimed by a person entitled to file a claim for refund under section 3485. Such person may pay its liability, if any, for the taxes imposed by chapters 21 and 24 for a calendar quarter and file a claim for refund of the total amount in respect of tax withheld upon dividends, interest, or patronage dividends received by it during that quarter.

In the case of a foreign central bank of issue, the provisions of section 3485 apply only to the tax under section 3451 deducted and withheld on interest on those obligations of the United States which are not held for, or used in connection with, the conduct of the bank's commercial banking functions or other commercial activities.

SECTION 3486. REFUND OF TAX TO CORPORATION

Section 3486 provides that in the case of a corporation (other than a corporation described in sec. 3485(a)), if the amount withheld as

tax on interest, dividends, or patronage dividends received during any quarter (other than the fourth quarter) of its taxable year exceeds the credit, if any, claimed by and allowable to the corporation for that quarter under section 3487 (which permits a corporation to offset the tax withheld under ch. 25 on amounts received by it against the tax it is required to withhold under ch. 25 on amounts paid by it), the excess (together with any such excess for any prior quarter of the same year with respect to which no refund has been claimed and allowed under sec. 3486) is to be promptly refunded to the corporation as an overpayment of tax. A claim for refund under section 3486 must be filed by the corporation after the close of the quarter to which it pertains and on or before the close of its taxable year. Any tax under chapter 25 withheld on amounts received by the corporation during the fourth quarter of its taxable year may be claimed as a credit under section 39 against its income tax liability for the year.

SECTION 3487. CREDIT FOR TAX WITHHELD ON CORPORATION

Section 3487(a) provides that tax deducted and withheld under chapter 25 on interest, dividends, or patronage dividends received by a corporation (other than a corporation described in sec. 3485(a)) during a taxable year will, to the extent not claimed and allowable as a credit or refund to the corporation during a prior quarter under section 3486, be allowed, under regulations prescribed by the Secretary of the Treasury or his delegate, as a credit against (but not in excess of) the tax for which the corporation is liable under chapter 25 in respect of dividends, interest, and patronage dividends paid by it during such year. The credit must be claimed on the quarterly return required under section 3481. For example, if a corporation received during the first quarter of its 1963 taxable year dividends of $1,000 upon which tax was required to be withheld by the payor corporation under section 3461, the amount of the tax required to be withheld, or $200, may be applied by the corporation as a credit against its liability for the tax which it is required to deduct and withhold upon any dividends or interest paid by it during the first or any later quarter of the same taxable year. If, in this example, the corporation paid dividends of $750 during the first quarter on which it withheld $150, it may claim a credit of $150 against this $150 which it would otherwise be required to remit to the Government. The company may file a claim under section 3486 for refund of the remaining $50, or, if it does not file such a claim for refund, it may claim a credit under section 3487 for that amount against its liability for tax deducted and withheld by it under chapter 25 during a subsequent quarter of the same taxable year.

Section 3487(b) provides that if a dividend is treated as paid during the taxable year of a regulated investment company under section 855(a) or a real estate investment trust under section 858(a), such dividends may be considered for purposes of section 3487 as having been paid within the taxable year. Thus, the amount of tax withheld under chapter 25 with respect to dividends and interest received by a regulated investment company or a real estate investment trust during a taxable year may be allowed, under regulations prescribed by the Secretary of the Treasury or his delegate, as a credit against the tax which the company or trust is required to de-

duct and withhold upon the payment of any dividend declared and paid by it after the close of its taxable year, if the dividend is treated as having been paid during such taxable year under the provisions of section 855(a) or 858(a). Likewise, in the case of a personal holding company, the tax deducted and withheld on dividends and interest received by it during the taxable year may be allowed, under regulations prescribed by the Secretary or his delegate, as a credit under section 3487 against any tax under chapter 25 for which it is liable in respect of any dividend paid after the close of the taxable year and on or before the 15th day of the third month following the close of such taxable year, if such personal holding company elected under section 563(b) to have such dividend considered as paid during such taxable year. Comparable rules apply in the case of cooperatives.

Section 3487(c) provides that (to the extent and subject to such conditions as the Secretary or his delegate may provide in regulations) a credit under section 3487(a) may be allowed to one corporation for tax withheld on amounts received by another corporation during the same taxable year, if both corporations are members of an affiliated group which filed a consolidated return under chapter 6 of the 1954 Code for the preceding taxable year of the affiliated group.

SECTION 3488. OBLIGATION SOLD BETWEEN INTEREST-PAYMENT DATES

Section 3488 provides that, for purposes of any credit or refund authorized by chapter 25, the amount required to be deducted and withheld on the interest at the end of the interest-payment period will, in a case where the obligation is sold or exchanged between the interest-payment dates, be treated by the transferor and the transferee in the manner provided in section 39(c). Section 39(c) provides for the manner in which the tax shall be apportioned and the date on which the tax is treated as withheld from the transferor. If the transferor is eligible for a quarterly credit or refund under one of the provisions of chapter 25, he may claim the credit or refund of his allocable portion of the tax which will be deducted and withheld at the end of the interest-payment period as if such tax were actually withheld on the date of the transfer (since that is when it is treated as withheld under sec. 39(c)).

SECTION 3489. PRESUMPTION

The credits and refunds authorized by sections 39, 3505, and 3484 through 3487 are based on the amount of tax "deducted and withheld", and not on the amount "required to be deducted and withheld." In many cases recipients of amounts subject to withholding under chapter 25 will not receive statements from the withholding agent showing the amount deducted and withheld and, accordingly, will not have evidence in their possession to prove that the tax actually was deducted and withheld. Section 3489 provides that, for purposes of establishing that any person is entitled to a credit or refund under one of those sections, any tax under chapter 25 which was required to be deducted and withheld will, in the absence of evidence to the contrary, be presumed to have been deducted and withheld.

The presumption in section 3489 is a rebuttable one. Therefore, a recipient of interest, dividends, or patronage dividends who knows that the tax actually was not deducted and withheld is not entitled to claim a credit or refund of such tax. Furthermore, in any case where the Government can show that the tax for which credit or refund was claimed and allowed actually had not been deducted and withheld, the allowance of the credit or refund will be erroneous and the amount thereof may be recovered by the Government. However, no penalty will be imposed on a recipient of amounts with respect to which tax is required to be deducted and withheld under chapter 25 if such recipient in good faith, and in reliance on the presumption contained in section 3489, claimed a credit or refund of tax which later is shown not to have been deducted and withheld.

SECTION 3490. DEFINITIONS

The term "person" as used in chapter 25 includes the United States, a State, a foreign government, and an international organization. Definitions of certain of these terms are set forth in section 3490. For example, the term "State" is defined as including a State, the District of Columbia, a possession of the United States, any political subdivision of any of the foregoing, and any wholly owned agency or instrumentality of any one or more of the foregoing. See section 7701(a)(18) for definition of the term "international organization."

The term "nonresident alien individual" is defined as including an alien resident of Puerto Rico. Thus, for example, interest on deposits in a bank in the United States paid to an alien resident of Puerto Rico not engaged in trade or business within the United States is exempt from the provisions of section 3451 which provide for the deduction and withholding of tax on interest.

SECTION 19. WITHHOLDING OF INCOME TAX AT SOURCE ON INTEREST, DIVIDENDS, AND PATRONAGE DIVIDENDS (Continued)

(*b*) *Credits against income tax for tax withheld.*—Subsection (b) of section 19 of the bill amends part IV of subchapter A of chapter 1 of the code (relating to credits against tax) by inserting after the new section 38 (added by sec. 2 of the bill) a new section 39. Subsection (b) amends section 584(c) (relating to the income of participants of common trust funds), by adding a new paragraph at the end thereof, and section 642(a) (relating to special rules for credits and deductions in the case of estates and trusts), by adding a new paragraph at the end thereof.

SECTION 39. TAX WITHHELD ON INTEREST, DIVIDENDS, AND PATRONAGE DIVIDENDS

(*a*) *General rule.*—The credit provided by section 39(a) is allowed to the taxpayer against his income tax liability for the taxable year in which the interest, dividend, or patronage dividend is received. The term "received" includes constructive receipt.

Under the withholding system incorporated in chapter 25, no receipt or statement of the amount of dividends, interest, or patronage

dividends paid to the recipient or the amount of tax withheld is required to be furnished by the payor of these amounts.

An appropriate schedule will be supplied on which a recipient of interest, dividends, or patronage dividends upon which tax is required to be withheld at the source may determine the proper amount to be reported in gross income and the amount to be claimed as a credit under section 39(a). The recipient will enter on the form (1) the net amount of interest, dividends, and patronage dividends received after withholding, (2) the amount withheld which, at the 20-percent withholding rate, will be determined by computing one-fourth of the net amount received, and (3) the sum of the amount actually received and the amount withheld. The total of the amount actually received and the amount withheld is the sum to be taken into account in computing gross income. The recipient will be allowed a credit against his tax liability for the amount determined as tax withheld at source.

The "grossing-up" method which will be incorporated on the form may be illustrated by the following example:

A, an individual, prepares his income tax returns on the cash receipts and disbursements method of accounting and on the basis of the calendar year. During the calendar year 1964, A receives the following items of income:

(1) Dividends:

(*a*) A net amount of $800 from M Corporation representing dividends of $1,000, less the tax withheld.

(*b*) A net distribution of $130 from N Corporation, a regulated investment company, representing a capital gain dividend of $50, and an ordinary dividend of $100, less tax of $20 withheld on the ordinary dividend.

(2) Interest:

(*a*) A net amount of $64, representing $80 of interest on two $1,000 coupon bonds of P Corporation, less the tax withheld.

(*b*) A net amount of $240, representing $300 of interest upon the proceeds of a $10,000 life insurance policy (which were left with the company under an agreement to pay interest), less the tax withheld, paid by the Q Insurance Company.

A will exclude from the "gross-up" computation the payment of $50 received by him from the N Corporation, which represents a capital gain dividend, since a capital gain payment by a regulated investment company is excluded by section 3462(b)(2)(A) from withholding on dividends. With respect to dividends upon which tax is required to be withheld at source, he will include on the form the net amounts of $800 received from M Corporation after withholding, and $80 received from N Corporation after withholding. Thus, the total net amount of dividends, after withholding, included on the form will be $880. A will then enter, as the tax withheld, one-fourth of this amount, or $220. He will then enter $1,100 as the total amount of dividends received which were subject to withholding.

In the "gross-up" of interest, A will enter $64 on the form as interest received upon coupon bonds of P Corporation and $240 as interest received from the Q Insurance Company. He will then enter the total net amount of interest received after withholding, or $304. One-fourth of this amount, or $76, will be entered on the form as the amount of tax withheld at the source. A will then add the amount of tax withheld and the total net amount of interest received after withholding

and enter the sum, or $380, on the form as the total interest received. The total amounts of income tax withheld as shown on the form, $220 on dividends plus $76 on interest, or $296, is the amount allowable to A as a credit under section 39(a) against his final tax liability. If any of the $296 has been refunded to A during the year under section 3484, his credit under section 39(a) will be reduced by the amount so refunded.

(*b*) *Special rule for dependent children.*—Subsection (b) of section 39 provides that if a taxpayer for his taxable year is entitled to a deduction under section 151(e)(1)(B) for a child and the child had less than $600 of gross income for the calendar year ending with or within the taxpayer's taxable year, and in addition the child had no wages during such calendar year which were subject to wage withholding under chapter 24, then the taxpayer-parent may, under regulations prescribed by the Secretary of the Treasury or his delegate, claim for the child against his (the parent's) tax the credit provided in section 39(a) for the tax withheld under chapter 25 on amounts paid to the child during such calendar year. However, the parent may claim the credit only if the child has not filed any claim for credit or refund of any portion of the tax deducted and withheld under chapter 25 with respect to such amounts.

(*c*) *Apportionment of credit.*—Subsection (c) of section 39 provides that where an obligation is sold or exchanged between interest-payment dates, the credit for the tax withheld on the interest paid at the end of the interest-payment period is apportioned between the transferor and the transferee. The part apportioned to the transferor is that part which is allocable to the portion of the interest-payment period which ends on the date of the sale or exchange and is treated as an amount withheld from the transferor on the date of the sale or exchange. The part apportioned to the transferee is that part which is allocable to the portion of the interest-payment period which begins on the day after the date of the sale or exchange. It is expected that, as a result of these apportionment rules, the purchaser of an obligation will pay the seller only four-fifths of the amount of accrued interest. For example, assume that on December 30, 1963, A sells to B a bond on which interest of $100 is payable on March 31 and September 30 of each year. B pays A for the bond and $40 (80 percent of the $50 of interest then accrued) in cash for the accrued interest. Twenty dollars will be withheld on the $100 interest payment when it is paid on March 31, 1964. One-half of the $20, or $10, is apportioned to A and is treated as though withheld from him on December 30, 1963, for purposes of the credit or refund provided in section 39(a).

(*d*) *Limitations.*—Subsection (d) of section 39 contains several provisions which prevent the allowance of duplicate credits for the same amount of tax. Among these provisions is one which prohibits the allowance of any credit under section 39 to a person described in section 3485 (States, tax-exempt organizations, etc.) for any amount for which a credit could have been allowed under section 3505 or for which a credit or refund is allowable under section 3485. Another provision prohibits the allowance of credit under section 39 to any person required to deduct and withhold tax under section 1441 or 1442 for any amount for which a credit is allowed to such person under section 1444(b).

SECTION 584. COMMON TRUST FUNDS

The amendment made to section 584(c) of the 1954 Code by section 19(b)(2) of the bill provides that, for purposes of any credit or refund provided in section 39 or 3505, or chapter 25, any tax deducted and withheld under chapter 25 on any amounts received during any taxable year by a common trust fund will, in accordance with regulations prescribed by the Secretary or his delegate, be considered as having been deducted and withheld proportionately from each participant in the common trust fund.

SECTION 642. ESTATES AND TRUSTS

The amendment made to section 642(a) of the 1954 Code by section 19(b)(3) of the bill provides that, for purposes of any credit or refund provided by section 39 or 3505, or by chapter 25, any tax deducted and withheld under chapter 25 on any amounts received by an estate or trust will, in accordance with regulations prescribed by the Secretary of the Treasury or his delegate, be considered as having been deducted and withheld from each beneficiary in an amount which, when added to the amounts paid, credited, or required to be distributed to him, equals the amounts which would have been paid, credited, or required to be distributed to him in the absence of chapter 25. Any tax under chapter 25 which is deducted and withheld on amounts received by the estate or trust are to be considered as withheld from the estate or trust, to the extent not considered as withheld from a beneficiary.

The estate or trust will "gross-up" the net dividends and interest received by it. This procedure will enable it to determine the distributions to the beneficiaries and the amount of the tax to be considered as withheld from each beneficiary. The beneficiary will not include any dividends or interest received from the estate or trust in the "grossing-up" schedule on his return. He will, instead, show in the schedule provided on the return for reporting income from estates or trusts the information supplied to him by the executor or trustee as to his share of the dividends and interest and of the withheld tax.

The following examples illustrate the application of these provisions:

Example (1).—A is the beneficiary of a trust the entire income of which is interest received from domestic corporations. Under the terms of the trust instrument, the entire net income is currently distributable to A. Both A and the trust report on the calendar year basis. During the taxable year, the trustee received from the corporations a net amount of $8,000, representing interest of $10,000 less tax withheld of $2,000. The trust had expenses of $1,000 during the year and distributes $7,000 in cash to A. The trustee claims a deduction on the fiduciary return of $9,000 under section 651 for income distributed to A, computed as follows:

Interest (grossed-up)	$10, 000
Less expenses	1, 000
Distributable net income (sec. 643)	9, 000

Tax under chapter 25 in the amount of $2,000 is considered as withheld from A, computed as follows:

Total amount of interest which would have been distributed to A in the absence of chapter 25	$9, 000
Less amount paid to A	7, 000
Tax considered withheld from A	2, 000

The amount of interest received from the trust which is to be included in A's gross income is $9,000. A is entitled to claim a credit of $2,000 for the tax considered as withheld from him.

Example (2).—A, B, and C are beneficiaries of a trust which receives income in the form of interest and rentals from real estate. Under the terms of the trust instrument, all of the income derived from certain designated improved real estate is currently distributable to A, and all the income from other sources is currently distributable in equal portions to B and C. The income distributable to B and C includes interest from which tax was withheld. B and C are each entitled to one-half of the credit for the tax withheld since one-half of the tax is treated as having been withheld from each.

Example (3).—A and B are beneficiaries of a trust. B is a minor. Under the terms of the trust instrument, one-half of the net income of the trust is currently distributable to A and the other half is required to be accumulated by the trustee and added to corpus until B reaches the age of 21 years. Thereafter, the net income of the trust is currently distributable one-half to A and one-half to B. Both A and the trust report on the calendar year. During the taxable year the trust received the net amount of $8,000 from domestic corporations, representing interest of $10,000 less tax withheld of $2,000. It had other income not subject to withholding, against which the trustee elected to offset the expenses of the trust. Interest of $5,000 ($4,000 in cash plus $1,000 tax which is treated as withheld from A) may be distributed to A and deducted by the trust under section 661. A would include $5,000 in his gross income and would be allowed a credit of $1,000 for the tax which is treated as having been withheld from him. The trust would be entitled to a credit of $1,000 of tax withheld which is attributable to the portion of interest ($5,000) taxable to it as income not distributable to any beneficiary during the taxable year.

SECTION 19. WITHHOLDING OF INCOME TAX AT SOURCE ON INTEREST, DIVIDENDS, AND PARTONAGE DIVIDENDS (Continued)

Technical amendments

Section 19(b)(4) of the bill makes several technical changes in the 1954 Code. It amends section 164(b)(1), relating to nondeductibility of certain taxes in computing taxable income for purposes of subtitle A of such code, by adding a new subparagraph (D) to provide that no deduction is to be allowed for tax withheld at source under chapter 25. Section 874(a) of the 1954 Code, which makes the filing of a return a

prerequisite to the allowance of deductions and credits to a nonresident alien, is amended to add the credit under section 39 to the credits for tax withheld at source which section 874(a) is not to be construed as denying. Section 1314(e) of the code, relating to nonapplicability of part II of subchapter Q of chapter 1 (mitigation of effect of limitations) to subtitle C taxes, is amended to show that subtitle C relates to collection of income tax at source, as well as to employment taxes. Section 6211 of the code, relating to the definition of a deficiency, is amended to include the credit provided by section 39 among the items, such as payments of estimated tax, which are to be disregarded in determining what constitutes "the tax imposed by chapter 1" and "the tax shown on the return" for purposes of such section.

(c) *Interest and dividends paid to nonresident aliens, etc.*—Section 19(c) of the bill amends subchapter A of chapter 3 of the code by adding new material to section 1441 (relating to withholding of tax on nonresident aliens) and section 1442 (relating to withholding of tax on foreign corporations) and by adding a new section 1444.

The withholding rate applicable generally under existing sections 1441 and 1442 to interest and dividends is 30 percent, but this withholding rate has been modified by regulations to conform to the various lower tax rates, ranging all the way down to zero, provided by tax treaties.

Section 19(c)(1) of the bill amends sections 1441 and 1442 to provide that the tax required to be deducted and withheld under these sections will not by reason of the provisions of any treaty be less than 20 percent in the case of amounts described in section 3452(a) (relating to interest), section 3462(a) (relating to dividends), and section 3472(a) (relating to patronage dividends).

Section 19(c)(2) of the bill adds section 1444 to the code. Subsection (a) of the new section 1444 authorizes a nominee of a nonresident alien or of a foreign corporation, who is required to deduct and withhold tax under section 1441 or 1442 on interest, dividends, or patronage dividends transmitted by him to such beneficial owner, to notify a payor of such amounts to that effect. Thereafter such payor is not to deduct and withhold tax under chapter 25 on such amounts but is required to deduct and withhold tax under section 1441 or 1442 on the amounts paid to the nominee at the same rate as the payor would deduct and withhold if the payor were paying such amounts directly to the beneficial owner. If the nominee so notifies the payor, the nominee is relieved of responsibility for deducting and withholding tax under section 1441 or 1442.

In any case where tax under chapter 25 was deducted and withheld (or, in the case of a transfer between interest-payment dates, was treated as deducted and withheld under sec. 39(c)) on amounts received by a person who is under an obligation to deduct and withhold tax under section 1441 or 1442 on the same amounts, such person can, under section 1444(b), claim a credit for the chapter 25 tax deducted and withheld (or so treated) from him against his liability for payment of the tax which he is required to deduct and withhold under section 1441 or 1442. Section 1444(b) applies to all persons, and not just nominees, required to deduct and withhold under section 1441 or 1442.

(d) *Credit for States and tax-exempt organizations.*—Subsection (d) of section 19 of the bill adds a new section 3505 to chapter 26 of the code

(general provisions relating to employment taxes and income tax withheld at source).

The new section 3505 provides that, in the case of a person which is a State (as defined in sec. 3490(2) of the code) or which is an organization (other than a cooperative described in sec. 521 of the code) exempt from income tax, the tax deducted and withheld under chapter 25 with respect to amounts received by it during any calendar quarter is to be allowed, under regulations prescribed by the Secretary of the Treasury or his delegate, as a credit against (but not in excess of) such person's liability (after the adjustments, if any, provided for in secs. 6205(a) and 6413(a) of the code) for such quarter for the taxes imposed by chapter 21 (relating to the Federal Insurance Contributions Act) and by chapter 24 (relating to the collection of income tax at source on wages). This credit is to be allowed only if claim therefor is made, in accordance with such regulations, at the time of the filing of the return with respect to the taxes under chapter 21 and chapter 24 for such quarter.

Section 3505 permits a State or tax-exempt organization to offset the taxes withheld under chapter 25 on amounts received by it during a calendar quarter against its liability for the taxes imposed by chapter 21 and chapter 24 for the same calendar quarter. If the tax withheld from amounts paid to a State or tax-exempt organization exceeds the credit provided by section 3505, the excess will be refunded under the provisions of section 3485.

The term "received" as used in section 3505 includes constructive receipt. Thus, in the case of interest constructively received in a calendar quarter, the tax withheld upon such interest may be claimed as a credit, even though the interest is not actually collected until a subsequent quarter.

The credit provided for in section 3505 may be claimed only with respect to tax deducted and withheld on amounts received during a calendar quarter. If tax withheld upon amounts received during a calendar quarter is not claimed as a credit under section 3505 against taxes due under chapter 21 and chapter 24 for such quarter, no credit may thereafter be claimed for such tax under section 3505. However, a refund may be claimed for such tax under section 3485. The credit provided by section 3505 may not exceed the liability (after any adjustment made under sec. 6205(a) or 6413(a)) of the State or tax-exempt organization for the calendar quarter for the taxes imposed by chapter 21 and chapter 24.

Subsection (d)(2) of section 19 of the bill amends section 3502 of the code by adding a new subsection (c) thereto which provides that the tax deducted and withheld under chapter 25 is not to be allowed as a deduction in computing taxable income under subtitle A either to the person deducting and withholding the tax or to the recipient of the amounts subject to withholding.

(*e*) *Other technical amendments.*—Subsection (e) of section 19 of the bill makes several technical amendments to subtitle F of the code which are necessitated by the other provisions of section 19 of the bill.

Declaration of estimated income tax by individuals: Section 19(e)(1) of the bill amends section 6015 of the 1954 Code (relating to declarations of estimated income tax by individuals) to take into account tax withheld under chapter 25. Section 6015 now provides that a declaration of estimated tax is to be filed for the taxable year

if (1) the gross income for such taxable year can reasonably be expected to exceed certain specified amounts, or (2) the gross income for the taxable year from sources other than wages subject to withholding can reasonably be expected to exceed $200. Section 6015, as amended, will change the latter requirement so as to require the filing of a declaration if the gross income from sources other than wages, interest, dividends, or patronage dividends subject to withholding can reasonably be expected to exceed $200.

Adjustment of tax (underpayments): Section 19(e)(2) of the bill amends section 6205 of the code to extend to tax deducted and withheld under chapter 25 the special rules for adjustment of underpayments of tax now applicable to tax deducted and withheld on wages. Under these rules, as revised, if less than the correct amount of tax is paid or deducted with respect to any remuneration, interest, dividends, or other amounts, proper adjustments are to be made, without interest, in such manner and at such times as the Secretary of the Treasury or his delegate may by regulations prescribe. If the underpayment of tax cannot be adjusted, it is to be assessed and collected, in such manner and at such times (subject to the statute of limitations properly applicable thereto) as may be prescribed by regulations.

Use of Government depositaries: Section 19(e)(3) of the bill amends section 6302(c), relating to the use of Government depositaries, to provide that, in the case of tax required to be deducted and withheld under chapter 25 (relating to collection of income tax at source on interest, dividends, and patronage dividends), deposit of the tax in a Government depositary may not be required under section 6302(c) at any time before the last day prescribed in section 3481 for payment of the tax; that is, the last day of the first month following the close of the quarter in which the tax was deducted and withheld.

Excessive withholding treated as overpayment: Section 19(e)(4) of the bill amends section 6401(b) of the code, relating to excessive withholding. Section 6401(b) now provides that if the amount allowable as a credit under section 31 (relating to credit for tax withheld at the source on wages under ch. 24) exceeds the taxes imposed by chapter 1 against which such credit is allowable, the amount of the excess is considered an overpayment. Such section is amended to provide that if the amounts allowable as credits under section 31 and section 39 (relating to credit for tax withheld under ch. 25) exceed the taxes imposed by chapter 1 against which such credits are allowable, the amount of such excess is to be considered an overpayment.

Adjustment of tax (overpayments): Section 19(e)(5) of the bill amends section 6413 of the code to extend to tax deducted and withheld under chapter 25 the special rules for adjustment of overpayments of tax now applicable to tax deducted and withheld on wages. Under these rules, as revised, if more than the correct amount of tax is paid or deducted with respect to any remuneration, interest, dividends, or other amounts, proper adjustments are to be made, without interest, in such manner and at such times as the Secretary of the Treasury or his delegate may by regulations prescribe. If the overpayment of tax cannot be adjusted, it is to be refunded in such manner and at such times (subject to the statute of limitations properly applicable thereto) as may be prescribed by regulations.

Overpayment not deducted and withheld: Section 19(e)(6) of the bill amends section 6414 of the code, relating to refunds or credits to

employers or withholding agents, so as to extend the restrictions on such credits or refunds to amounts withheld under chapter 25.

Presumptions as to date of payment: Section 19(e)(7) of the bill amends section 6513(b) of the code, which relates to the time tax withheld on wages and estimated income tax payments are deemed to have been paid for purposes of determining the time within which an allowable claim for credit or refund must be filed. New sentences are added to section 6513(b) to provide that the amount allowable as a credit under section 39 (relating to credit for tax withheld under ch. 25), or as a credit or refund under chapter 25 (other than sec. 3487), will, in respect of the person entitled to such credit or refund, be deemed to have been paid by him on the last day prescribed for filing the return under section 6012 (determined without regard to any extension of time for filing such return) for his taxable year in which the amount subject to withholding under chapter 25 is received by him. As used in the amendment to section 6513(b), the term "taxable year in which the amount subject to withholding under chapter 25 is received by him" means in a case where an amount subject to withholding is required to be included in the gross income of a taxpayer even though not actually distributed to him, the taxable year in which such amount is includible in the taxpayer's gross income. The new sentences also provide special rules as to the time tax is considered paid by persons (such as States, tax-exempt organizations, etc.) not required to file returns, and by a parent claiming credit for tax withheld on amounts received by his child. These rules will, by reason of a reference to section 6513 contained in section 6611, also be applicable in determining when interest will be paid on overpayments attributable to withholding under chapter 25.

Failure to pay estimated income tax: Section 19(e)(8) of the bill amends section 6654 of the code, relating to failure by an individual to pay estimated income tax, to provide in respect of the credit under section 39 (relating to credit for tax withheld under ch. 25) the same treatment as is now provided in respect of the credit under section 31 (relating to credit for tax withheld on wages). As amended, section 6654(e) provides that the estimated tax will be computed without any reduction for the amount which the individual estimates as his credit under section 31 or section 39. It further provides that the amount of credit allowed under sections 31 and 39 for the taxable year will be deemed a payment of estimated tax, and that an equal part of such amount shall be deemed paid on each installment date for such taxable year, unless the taxpayer establishes the dates on which all amounts were actually withheld (or in the case of an amount described in sec. 39(c)(1) the date when the amount is treated as withheld), in which case the amounts so withheld will be deemed payments of estimated tax on the dates on which such amounts were actually withheld (or so treated as withheld). Section 6654(f), as amended by section 19(e)(8) of the bill, provides that for purposes of determining the amount of the underpayment under section 6654(b) and the applicability of the exceptions contained in section 6654(d), the term "tax" means the tax imposed by chapter 1 reduced by the credits against tax allowed by part IV of subchapter A of chapter 1, other than the credits against tax provided by sections 31 and 39.

Section 19(e)(8) of the bill also amends section 6655 of the code, relating to failure by a corporation to pay estimated income tax, to

provide that the estimated tax is to be computed without any reduction for the amount which the corporation estimates as its credit under section 39, that the credit allowed the corporation under section 39 for the taxable year is to be deemed a payment of estimated tax, an equal part of which is to be deemed paid on each installment date for the taxable year, unless the dates on which the tax was actually withheld (or in the case of an amount described in sec. 39(c)(1) the date when the amount is treated as withheld) are established, and that, for purposes of determining the amount of the underpayment under section 6655(b) and the applicability of the exceptions contained in section 6655(d), the term "tax" means the tax without any reduction for the amount which the corporation estimates as its credit under section 39.

Penalty for filing fraudulent exemption certificate or failure to give required notice: Section 19(e)(9) of the bill amends section 7205 of the code to provide a penalty for the willful filing of an exemption certificate under section 3483 which is known by the person filing it to be false or fraudulent as to any material matter. The penalty is a fine of not more than $500, imprisonment for not more than 1 year, or both. A similar penalty is provided in respect of the willful failure of an organization which has lost its tax-exempt status to give notice of that fact, as required by section 3483(a)(3)(B), to each payor with which it has filed an exemption certificate.

Separate accounting for collected taxes: Section 19(e)(10) of the bill amends section 7215, which provides a penalty for failure to comply with any provision of section 7512(b), relating to separate accounting for the taxes imposed by subtitle C or by chapter 33. Section 7215 provides that the penalty is not to apply to any person who shows that his failure to comply was due to circumstances beyond his control. The section also provides however, that a lack of funds existing immediately after the payment of wages (whether or not created by the payment of such wages) will not be considered to be circumstances beyond the control of a person. Section 19(e)(10) of the bill amends this latter provision so that it will apply not only to wages but also to amounts subject to withholding under chapter 25.

Definition of withholding agent: Section 19(e)(11) of the bill makes a conforming amendment to section 7701(a)(16) of the code, relating to the definition of "withholding agent," by adding references therein to sections 3451, 3461, and 3471.

(*f*) *Effective dates.*—Subsection (f) of section 19 of the bill provides effective dates for such section 19. Paragraph (1) of subsection (f) makes the provisions of the bill generally applicable to interest and dividends paid on or after January 1, 1963. Special rules are provided in paragraph (2) with respect to certain transferable obligations and patronage dividends. Subparagraph (A) of paragraph (2) provides that in the case of interest on transferable obligations such as bonds, debentures, notes, certificates, or other evidences of indebtedness issued by a corporation, and in the case of interest on transferable obligations of the United States, the provisions of the bill are to apply only to such interest paid with respect to interest-payment periods commencing on or after January 1, 1963. Subparagraph (B) of paragraph (2) provides the effective date as to amounts described in section 3472. Such amounts paid on or after January 1, 1963, with respect to patronage occurring on or after the first day of the first

taxable year of the cooperative beginning on or after January 1, 1963, are to be subject to the withholding tax; whereas, amounts paid on or after January 1, 1963, with respect to patronage occurring before the first day of the first taxable year of the cooperative beginning on or after January 1, 1963, are not to be subject to the withholding tax.

SECTION 20. INFORMATION WITH RESPECT TO CERTAIN FOREIGN ENTITIES

(*a*) *Information to be furnished by individuals, domestic corporations, etc., with respect to certain foreign corporations.*—Subsection (a) of section 20 of the bill amends section 6038 of the 1954 Code. Section 6038(a)(1) requires every United States person to furnish the information required by such section with respect to any foreign corporation which such person controls (as defined in section 6038(d), as amended by the bill). Under existing law, the obligation to furnish information is imposed only on domestic corporations and only with respect to controlled foreign corporations and foreign subsidiaries of such controlled foreign corporations.

The requirements as to the information to be furnished are not changed except that (1) because of the redefinition of "control" including the addition of most of the constructive ownership rules of section 318(a) of the 1954 Code, there will be an increase in the number of persons whose transactions with controlled corporations must be reported, and (2) the Secretary of the Treasury or his delegate is authorized to require the furnishing of any other information which is similar or related in nature to that specified in paragraph (1) of section 6038(a) as amended by the bill.

Under the amendment made by section 20(a) of the bill, the period for which information is to be furnished under section 6038(a)(2) is modified to provide that, in all cases, such period is that ending with or within the United States person's taxable year. The amendment does not change the period with respect to a first-tier foreign corporation. However, with respect to a foreign subsidiary of such corporation, the period is changed from that ending with or within the first-tier corporation's annual accounting period to that ending with or within the United States person's taxable year. Thus, the effect of the amendment will be to obtain information which is more current from the sub-subsidiary.

Section 6038(a)(3), as amended by the bill, is the same as existing law. It provides that no information will be required to be furnished under section 6038(a) with respect to any foreign corporation for any annual accounting period unless such information was required to be furnished under regulations in effect on the first day of such annual accounting period.

Section 6038(b), which sets forth the penalty for failure to file the required information within the prescribed time, is amended to provide that the reduction in foreign taxes paid or deemed paid now provided by section 6038(b) will occur in applying section 901 as well as section 902, although it will not occur under both sections with respect to the same tax. In addition, the reduction is to apply in respect of taxes deemed paid under section 957 of the code (added by sec. 13(a) of

the bill). Also, the penalty provided by section 6038(b), as amended by the bill, is extended to other than corporate taxpayers.

The reduction in foreign taxes paid or deemed paid for failure to file the required information within the prescribed time is not to apply, however, in computing accumulated profits in excess of income, war profits, and excess profits taxes under section 902 (a) and (b) of the code (relating to foreign tax credit for a corporate stockholder of a foreign corporation).

The effects of section 6038(b), as amended by the bill, on section 78 as added by section 11 of the bill, and on the computation of a foreign tax credit under section 902(a), may be illustrated by the following example involving corporation A, a domestic corporation which owns 100 percent of the voting stock of corporation B, a foreign corporation. It is assumed the dividend from corporation B is the only dividend received from a foreign corporation by corporation A.

(i)	Gains, profits, and income of corporation B	$100, 000
(ii)	Foreign tax paid by corporation B with respect to such gains, profits, and income	40, 000
(iii)	Reduction of foreign tax paid by corporation B, resulting from corporation A's failure to file information with respect to corporation B as required by section 6038(a): 90-day failure to file, 10 percent reduction; additional 3 months failure to file, 5 percent reduction; total reduction, 15 percent. $40,000 × 15 percent	6, 000
(iv)	Foreign tax paid by corporation B after section 6038(b)(1)(B) reduction	34, 000
(v)	Dividend paid by corporation B to corporation A	45, 000
(vi)	Accumulated profits of corporation B computed without reduction for foreign taxes (sec. 902(c))	100, 000
(vii)	Accumulated profits of corporation B reduced by foreign taxes (sec. 902(a))	60, 000
(viii)	Corporation A is deemed to have paid the same proportion of the total tax paid by corporation B, after reduction, as dividends, without regard to section 78, bear to accumulated profits in excess of taxes, without reduction by reason of sec. 6038(b)(1)(B): $34,000 × $45,000 ÷ $60,000	25, 500

Corporation A must include $25,500 in gross income as a dividend under section 78. The above example illustrates with respect to reductions in foreign taxes paid by the foreign corporation that (1) such reductions are taken into account in determining the amount included in gross income as foreign taxes deemed paid under section 78, as added by section 11 of the bill, and (2) such reductions are not taken into account in computing accumulated profits for purposes of determining the amount of foreign taxes deemed paid with respect to a particular dividend.

Section 6038(c), as amended by the bill, provides that where two or more persons are required to furnish information with respect to the same controlled foreign corporation for the same period, the Secretary of the Treasury or his delegate may prescribe that such information will be required only from one person. To the extent practicable, the Secretary's determination is to be based on actual ownership of stock (as distinguished from constructive ownership).

Section 6038(d) defines "control" as the possession of more than 50 percent of the combined voting power, or of the value, of all classes of stock. A person in control of a corporation which, in turn, owns more than 50 percent of the combined voting power, or of the value, of all classes of stock of another corporation is also treated as in

control of such other corporation. Thus, for example, in the case of a chain of corporations consisting of corporation M, owning 51 percent of the voting stock in corporation N, owning, in turn, 51 percent of the voting stock in corporation O, owning, in turn, 51 percent of the voting stock in corporation P; corporation P is controlled by corporation M. The rules of section 318(a) apply in determining stock ownership, except that the rule which requires ownership of 50 percent of the stock of a corporation before stock owned by such corporation is attributed to its stockholders does not apply. The constructive ownership rules apply in determining control of domestic and foreign corporations but not in determining, under section 6038(a)(1)(D)(iii), whether a transaction is with a corporation 10 percent or more of the value of any class of stock of which is owned by a United States person.

The amended section 6038(d) defines the "annual accounting period" of a foreign corporation as the annual period on the basis of which such corporation regularly computes its income in keeping its books.

Section 6038(e) provides cross-references to sections 7203 and 7701(a)(30), respectively, for provisions relating to penalties for violations of section 6038, and for the definition of the term "United States person".

(*b*) *Information as to organization or reorganization of foreign corporations and as to acquisitions of their stock.*—Subsection (b) of section 20 of the bill amends section 6046 of the 1954 Code.

Paragraph (1) of section 6046(a), as amended by the bill, requires an information return from each United States citizen or resident who, on January 1, 1963, is an officer or director of a foreign corporation or who becomes such an officer or director at any time after that date.

Paragraph (2) of section 6046(a) requires each United States person to file an information return under any of the following circumstances:

(1) He owns 5 percent or more in value of the stock of a foreign corporation on January 1, 1963.

(2) He owns stock of a foreign corporation on January 1, 1963, which has a value of less than 5 percent of the value of the stock of such corporation, or owns no stock on January 1, 1963, and thereafter acquires stock which, when added to the stock held on January 1, 1963, if any, has a value equal to 5 percent or more of the value of the stock of such foreign corporation.

(3) He acquires an additional 5 percent or more in value of the stock of a foreign corporation.

Paragraph (3) of section 6046(a) requires each person who becomes a United States person after January 1, 1963, while owning 5 percent or more in value of the stock of a foreign corporation to file an information return.

Example.—A, a United States person, who on January 1, 1963, owns 2 percent in value of the stock of foreign corporation M is not required to file an information return under section 6046. However, when he acquires, on April 1, 1963, an additional block of stock consisting of 4 percent in value of the stock of such corporation, he is required by subparagraph (A) of section 6046(a)(2) to make an information return with respect to corporation M. If, on December 31, 1964, he acquires a 6 percent block of stock in addition to that already owned, he is required to file a return under subparagraph (B) of section 6046(a)(2). He is not required to report when, on May 1, 1965, he acquires an

additional 3 percent block of stock, but he is required to report under subparagraph (B) when, on November 30, 1965, he acquires a 4 percent block of stock because the last two blocks of stock total more than 5 percent.

Subsection (b) of section 6046, as amended by the bill, is the same as existing law. It provides that the information returns required by subsection (a) of section 6046 shall be in such form and shall set forth, in respect of the foreign corporation, such information as the Secretary of the Treasury or his delegate prescribes by forms or regulations as necessary for carrying out the provisions of the income tax laws.

Subsection (c) of section 6046 is amended by omitting the definition of "United States shareholder". The term "United States person", as used in sections 6038 and 6046, as amended by the bill, has the same substantive meaning as the term "United States shareholder" in existing section 6046.

Subsection (d) of section 6046, as amended by the bill, provides a limitation on the time for filing a return required by subsection (a) of such section. Such return must be filed on or before the 90th day after the day on which, under any provision of section 6046(a), the United States citizen, resident, or person becomes liable to file such return.

Subsection (e) of section 6046, as amended by the bill, is a cross reference to section 7203, relating to willful failure to file a return, supply information, or pay tax.

(*c*) *Civil penalty for failure to file return.*—Subsection (c) of section 20 of the bill amends subchapter B of chapter 68 (relating to assessable penalties) by adding new section 6678.

Subsection (a) of section 6678, similar in purpose to section 6677 (relating to failure to file information returns with respect to certain foreign trusts) as added by section 9(g) of the bill, provides that in addition to any criminal penalty provided by law, any person required to file a return under section 6046 who fails to file such return at the time provided in section 6046, or who files a return which does not show the information required pursuant to such section, must pay a penalty of $1,000, unless it is shown that such failure is due to reasonable cause.

Subsection (b) of section 6678 provides that subchapter B of chapter 63 (relating to deficiency procedure for income, estate, and gift taxes) is inapplicable in respect of the assessment or collection of any penalty imposed by subsection (a).

(*d*) *Technical amendments.*—Subsection (d) of section 20 of the bill contains technical amendments adding a cross reference to section 318 of the Code and conforming the appropriate table of sections to the change in the heading of section 6046.

(*e*) *Effective date.*—Under subsection (e) of section 20 of the bill, section 6038 of the code as amended by the bill is to apply with respect to annual accounting periods of foreign corporations beginning after December 31, 1962, and section 6046 of the code as amended by the bill is to take effect on January 1, 1963. Under subsection (e)(1), existing section 6038 will continue to apply in respect of a foreign corporation or foreign subsidiary whose annual accounting period begins before January 1, 1963. For example, assume that D, a domestic corporation, has a taxable year beginning July 1, 1963, and

ending June 30, 1964. F, a foreign corporation controlled by D, has an annual accounting period beginning January 1, 1963, and ending December 31, 1963. FS, a foreign subsidiary of F, has an annual accounting period beginning April 1, 1962, and ending March 31, 1963. Under the effective date provision, information with respect to FS's annual accounting period beginning April 1, 1962, and ending March 31, 1963, is to be furnished under existing law, and information with respect to F's annual accounting period beginning January 1, 1963, and ending December 31, 1963, is to be furnished under section 6038 as amended by the bill.

SECTION 21. TREATIES

Section 7852(d) of the 1954 Code provides that no provision of the 1954 Code shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on August 16, 1954. Section 21 of the bill provides that section 7852(d) shall not apply in respect of any amendment made by the bill, thus making it clear that in the event there is any conflict with any treaty provision (whether or not such provision was in effect on Aug. 16, 1954) the provisions of the bill are to govern.

SEPARATE VIEWS OF THE REPUBLICANS ON H.R. 10650

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SEPARATE VIEWS OF THE REPUBLICANS ON H.R. 10650

General Statement

H.R. 10650 violates the concepts of sound tax policy and fiscal responsibility. By itself, the bill's $1.5 billion loss in revenue insures that the Kennedy budget's proposed $500 million surplus for fiscal 1963 will become a $1 billion deficit. This conscious creation of a deficit flies in the face of the President's warning in his budget message that "to plan a deficit under such circumstances would increase the risk of inflationary pressures, damaging alike to our domestic economy and to our international balance of payments."

The administration's approach to tax reform cannot provide this Nation with a tax structure that will insure continued healthy and noninflationary economic growth. Further, this approach can only serve to pile complexity upon complexity for the citizen who must cope with a tax code already much too complex. The answer to our tax problems will not be found in patchwork legislation. If the huge revenue loss in this bill were to result in sound, growth-inducing tax policy, Congress might be justified in accepting the risks involved. This bill, however, does not represent sound tax policy. It represents precisely the opposite.

Our concern centers on its three major provisions:

(1) The so-called "investment credit" perverts the tax laws into a $2 billion annual subsidy to one segment of the business community and constitutes nothing less than a discriminatory "loophole" which will have to be dealt with by a future Congress (sec. 2).

(2) To defray part of the cost of the investment subsidy, 20 percent will be withheld on dividends and interest, regardless of whether or not money is actually owed to the Government. To the extent that part of the investment subsidy is paid for by this departure from our voluntary compliance system, a large share will be money to which the Government may not be entitled (sec. 19).

(3) The proposed treatment of income earned abroad by a "controlled" foreign corporation discards the long-established concept that our economy, our national security, and the growth and independence of the free world depends on the expansion of American foreign trade and American business overseas (sec. 13).

The so-called "investment credit" (sec. 2) and taxation of the undistributed income of the "controlled" foreign corporation (sec. 13) are intended, not for the purpose of raising revenue, but to direct and control the future conduct of American business both at home and abroad. This is the "carrot and stick" method of Government regulation of business.

The "investment credit" is nothing more than a tax "gimmick." It is outright annual subsidy of $2 billion to a segment of the business

economy, which business as a whole neither seeks nor wants. It ignores the service industries, and the distribution and retail segments of our economy. It favors the large, and it penalizes the small. For example, one large company and its affiliates will receive a subsidy of more than $100 million, which the company is not seeking and does not want. This is the equivalent of one-sixth of the revenue that withholding, with its inconvenience to many millions of small investors, is supposed to produce.

Withholding on dividends and interest will be an administrative monstrosity, as was apparent by the difficulty which the committee had in adopting any withholding procedure. The provision for individual exemption certificates, adopted as a "last minute" measure, merely compounds the problem. The withholding provision now has all the inequities of massive "overwithholding" as well as the administrative burden on both the payer and the Treasury of multitudinous exemption certificates. It is conservatively estimated that there will be more than 500 million dividend and interest accounts which are affected by the withholding provision. At least one-third of these will involve withholding of nominal amounts, probably less than $1 per year. The qualification for filing an exemption certificate is so restrictive that many individuals will undoubtedly be hesitant to file, even though they may owe no tax.

The Government is investing millions of dollars in "computers" for processing information returns. The individual taxpayer is paying for that equipment. Indirectly, the individual taxpayer is also paying for the administrative expense which will be incurred by the payer in complying with these withholding procedures. With all of this, the individual must still be put to the unnecessary trouble and expense of annually filing exemption certificates and/or claims for refund for nominal amounts in order to avoid the collection of a tax which is not due. Instead, we urge that the Government be required to utilize the information returns procedure, the newly authorized taxpayer identification numbers, and the data-processing equipment, to save the individual from such inconvenience and expense.

With respect to the treatment of income earned abroad, we have in the past proceeded on the theory that the expansion of American foreign trade and American business overseas was indispensable to our national defense, to our domestic economy, and to the growth and freedom of the free world. In contrast to this policy, the bill seeks to build a "Berlin wall" in the tax laws to keep the American businessman at home. The bill would deny to American business the right enjoyed by its foreign competitors to go into any area of the free world where there might be a market, a source of raw materials, or the workers needed to make the business a success. The policy of this bill is a policy of "internationalism" as to foreign-owned business and "isolationism" as to American-owned business.

Discussion of Credit for Investment in Depreciable Property

BILL FORESHADOWS $2.5 BILLION BUDGET DEFICIT

For the fiscal year 1963, it has been estimated that the investment credit will result in a revenue loss of $1.8 billion, without taking into account any increase in the level of investment. If there is even a

minimum "incentive"—and "incentive" is the administration's justification for the proposal—the revenue loss will be more than $2 billion. Offsetting this, the estimated revenue provisions of the bill will produce only $250 million in fiscal 1963, mainly from withholding. The enactment of this bill will result in a loss of more than $1.5 billion in the Federal revenues for fiscal 1963. The budget as presented by the President for the fiscal year 1963 showed a surplus of less than $500 million. It can readily be seen that this bill taken by itself will convert that speculative surplus in the President's budget to a deficit of at least $1 billion.

Even on a "full year effect" basis, the bill produces a revenue loss of $775 million—and this has been heralded as only the "first step" in the Kennedy administration's tax "reform" program. The Treasury's proposed administrative revision of the depreciation schedules, soon to be released, is reported to involve a revenue loss of an additional $1.5 to $2 billion. When this is added to the cost of this bill, the net result will be a deficit in fiscal 1963 of $2.5 billion.

BUSINESS AND LABOR OPPOSE INVESTMENT CREDIT

The investment credit was initially proposed by the Kennedy administration to stimulate new "productive" investment which would not otherwise be undertaken. In this bill, however, the credit was extended to all investment in specific types of property, whether or not induced by the credit. It is also extended to all manufacturing industries, hotels and motels, public carriers, utilities, farming, and any other business in which tangible personal property is used. Although the hotels and motels, and certain regulated public utilities were excluded in the original proposal, the committee extended the credit to them, but at a reduced rate in the case of the utilities.

In the hearings on the tentative bill the support for the investment credit consisted almost exclusively of administration witnesses from the Departments of Treasury, Labor, and Commerce. The investment credit approach has been opposed by almost every major organization appearing before the committee. A representative list of those opposing the credit included the following:

Aerospace Industries Association.
AFL-CIO.
American Institute of Certified Public Accountants.
American Machine Tool Distributors Association.
American Meat Institute.
Brooklyn Chamber of Commerce.
Chamber of Commerce of the United States of America.
Committee for Economic Development.
Controllers Institute of America.
Copper & Brass Research Association.
Council of State Chambers of Commerce.
Edison Electric Institute.
Illinois State Chamber of Commerce.
International Union of Mine, Mill & Smelter Workers.
Lithographers & Printers National Association.
Machinery Dealers National Association.
National Association of Manufacturers.
National Small Business Men's Association.

Rubber Manufacturers Association, Inc.
Southern States Industrial Council.
Transportation Association of America.
U.S. Junior Chamber of Commerce.
United Shareholders of America.
Virginia Manufacturers Association.
Wisconsin Manufacturers Association.

It is a situation unique in the history of this committee, that the committee should insist on providing a tax benefit so overwhelmingly opposed by all segments of our society.

INVESTMENT CREDIT WILL NOT STIMULATE SOUND INVESTMENT

The investment credit is not a sound "incentive." A recent survey by the Wall Street Journal, the results of which were published on February 8, 1962, disclosed that of 68 companies surveyed, only 1 believed that the credit would have a significant effect on major expansion programs. There is no relationship between the revenue loss attributable to the credit and the additional expansion which the credit might produce.

On February 23, 1962, the AFL–CIO Executive Council, meeting at Bal Harbour, Fla., issued the following statement:

> The AFL–CIO has strongly and vigorously opposed the investment tax credit proposal as one that would grant a major tax windfall to corporations *without accomplishing its basic purpose of increasing the efficiency of American productive capacity.* [Italic supplied.]

This conclusion was supported by an array of witnesses in recent hearings before the Joint Economic Committee.

INVESTMENT CREDIT IS A TRUE "LOOPHOLE"

At a time when the Kennedy administration spokesmen are attacking various so-called "loopholes" in the revenue laws, the provision represents a "new frontier" in the field of special tax concessions.

The investment credit will not be reflected in the accounting for renegotiation, cost-plus-fixed-fee contracts, and redeterminable price contracts. In other words, the full cost of the item will be charged to the Government contract, without any provision for recapture of the investment credit in the case of excessive profits.

The provision grants a credit to the taxpayer, irrespective either of need or of prior obligation to make the investment. For example, an investment credit is granted for investment in U.S.-flag vessels although many U.S.-flag operators are already obligated to replace their older vessels and have funds set aside for that purpose. The Government already subsidizes 50 percent of the construction cost. The bill provides an "incentive" of 8 percent more.

The provision permitting either the lessor or the lessee of property to utilize the credit, at the election of the lessor, creates a further "loophole." A deduction or credit of this magnitude should not be left for "trading" as between taxpayers. In the case of leasing companies and other predominantly leasing businesses (i.e., computer rentals), the investment credit is tantamount to a 50-percent tax

reduction, or an effective tax rate of 26 percent. The lessee is the user of the equipment, whose business is affected by competition. It is the lessee who in fact ultimately pays for the equipment. Therefore, if anyone is to receive a credit for leased equipment, it should be the lessee.

Many lessors of equipment are, in substance, nothing more than finance companies. In some respects these lessors compete with the banks, insurance companies, and other lending institutions. The bill gives these types of institutions a tremendous advantage over the more conventional financing institutions.

INVESTMENT CREDIT IS INHERENTLY DISCRIMINATORY

An "incentive" approach to taxation is wrong. What constitutes an incentive to one taxpayer is a penalty to another taxpayer. The investment credit approach penalizes taxpayers who have expanded and modernized without having to rely upon any tax inducement. The allowance of a credit discriminates in favor of the taxpayers in a particular industry who have not kept abreast of technological developments within that industry. The effect is to subsidize a company which has lagged behind its competitors in plant modernization, at the expense of those competitors.

The investment credit discriminates *in favor* of transient hotels and motels and *against* residential hotels, apartments, and other rental housing. In fact, in the tax treatment of any investment which does not qualify for the investment credit, there is unwarranted discrimination.

An investment credit is provided for all qualified investments. Opinions may vary with respect to the extent to which the credit will act as a real incentive in increasing investment over the amount which would have been invested under existing law. However, a credit as high as 8 percent for all qualified investments is an excessive price to pay for the relatively lesser amount which could be attributed solely to the credit.

The graduation of the credit based upon the useful life of the asset recognizes a basic inequity from the standpoint of the investor. In dealing with assets having a useful life of 8 years and over—and most machinery and equipment would fall in that category—an investor in assets having a 10-year life would turn over his money twice as fast as an investor in assets having a 20-year life. Thus, on the same dollar investment over the same period of time the investor in the 10-year assets would receive a credit that was 200 percent of the credit that would accrue to the investor in the 20-year assets. However, in the case of public utilities, where the useful life is usually 20 years and over, the credit is cut in half.

Accelerated depreciation operates more nearly in relationship to increased investment than the investment credit. In the case of the investment credit, a taxpayer receives a benefit each year irrespective whether his net investment is increasing or declining. In the case of accelerated depreciation, the benefit declines if the investment declines, and the benefit is increased as the investment increases. Therefore, accelerated depreciation would be more consistent with the goals which the administration ostensibly is seeking.

INVESTMENT CREDIT IS A "WINDFALL," WHICH SHOULD BE DEDUCTED FROM THE DEPRECIATION BASE

Under existing law, taxpayers are permitted annually to deduct as depreciation a part of the cost of business or income-producing property over the period of its useful life. The revenue laws are so designed that the taxpayer will recover 100 percent of the cost of the property tax free over the period of its use. The investment credit is not a substitute for this allowance. The investment credit amounts, in essence, to payment by the Government of a part of the cost of acquiring depreciable property. It is logical, therefore, that the taxpayer should use as the cost to be recovered through depreciation only the net cost of the asset to the taxpayer—in the usual case, 92 percent of its gross purchase price. Otherwise, the investment credit will be a "windfall" to the taxpayer. A Republican-sponsored amendment to avoid giving the taxpayer such a "windfall" was rejected by the Democratic majority. The amendment merely required that the taxpayer deduct the amount of the investment credit—the subsidy—from the cost of the property. It is sound and should have been adopted.

Adjusting the basis of depreciable assets by the amount of the credit would also reduce the discrimination inherent in the investment credit in favor of relatively short-lived assets as compared with long-lived assets. While a business buying 8- or 10-year assets will still get an investment credit more frequently than a business investing in 20- or 30-year assets, if the adjusted basis of the assets is reduced by the amount of the credit, the business with the relatively short-lived assets will not have an unwarranted tax advantage over the business with longer lived assets because the former business will not be able to depreciate repeatedly that portion of the cost of the assets for which the Government has reimbursed it.

Republican Substitute for the Investment Credit

GENERAL

The undersigned members of the committee unanimously recommend that section 2 of the bill, relating to the investment credit, be stricken and that in lieu thereof there be inserted a substitute proposal which will provide for the following:

(1) An elective provision whereby taxpayers will be permitted to take additional depreciation each year in a graduated additional amount comparable to the brackets used for the investment credit. For assets having a useful life of 4 years and under 6 years, the additional depreciation would be 7 percent of the depreciation otherwise allowable. For assets having a useful life of 6 years and under 8 years, the additional depreciation would be 14 percent of the depreciation otherwise allowable. For assets having a useful life of 8 years or more, the additional depreciation would be 20 percent of the depreciation otherwise allowable.

(2) An elective provision whereby taxpayers will be permitted in valuing inventories to deduct and set up as a reserve an amount equal to 20 percent of the first $100,000 of finished goods purchased and held for resale, with the limitation that the amount deducted in any year will not exceed 50 percent of the net income.

This proposal recognizes the need for tax reform *both* for the manufacturing segment of the economy *and* for the distribution and sales segment of the economy.

The substitution will result in tax deferral—not tax forgiveness or tax subsidy. The continuing revenue loss will "average out" at about $1 billion per year. Thus, after the initial inventory writedown, the revenue loss is in line with the revenue-producing sections of the bill even if withholding on interest and dividends is eliminated. The proposed substitution would include in the allowance for depreciation the same assets that would qualify for the investment credit.

The provision with respect to depreciation, when coupled with the revision of Bulletin F by the Treasury, should provide industry with the latitude in accounting for depreciation which has been overwhelmingly supported in the testimony before the committee. As a corollary to the relief to industry, we also believe that the Congress should grant relief to the small businessman who must reinvest his funds in inventory. Unless the wholesale and retail trades are willing and able to stock the goods produced by industry, any increased capacity to produce will remain idle.

Discussion of Additional Depreciation Allowance

General Explanation

In the hearings before the committee, it was unanimously conceded that the provisions with respect to depreciation allowances for productive facilities, as supplemented by Bulletin F and the Treasury rulings, failed to recognize fully the economic obsolescence of such assets. The Secretary of the Treasury has publicly stated that the useful lives prescribed in Bulletin F will be consolidated and reduced by between 20 and 30 percent. However, he also advised the committee that after such revision, American industry still will not be permitted to amortize the cost of productive equipment as rapidly as its foreign competition. Therefore, we propose to provide for an election whereby the taxpayer can accelerate the depreciation of equipment to a greater extent than the revised Bulletin F.

The proposed amendment provides that the taxpayer will be permitted to take additional depreciation *each year* in a graduated additional amount, analogous to the brackets used for the investment credit:

> For assets having a useful life of 4 years and under 6 years, the additional depreciation would be 7 percent of the depreciation otherwise allowable.
>
> For assets having a useful life of 6 years and under 8 years, the additional depreciation would be 14 percent of the depreciation otherwise allowable.
>
> For assets having a useful life of 8 years or more, the additional depreciation would be 20 percent of the depreciation otherwise allowable.

For example, if a taxpayer installs some equipment having a useful life of 4 years on account of which the taxpayer would be entitled under existing law to an annual depreciation deduction of $100, this amendment would increase the annual deduction to $107. If the property had a useful life of 7 years, this amendment would increase

the annual deduction to $114. If the property had a useful life of 10 years, this amendment would increase the annual deduction to $120.

The additional depreciation provided for in the proposed amendment is based upon a percent of the depreciation otherwise allowed and would automatically reflect any increase in depreciation which might be allowed as a result of the pending Treasury study.

Under existing law, a taxpayer is permitted to compute depreciation under either (*a*) the *straight line method;* (*b*) the *sum of the years digits,* or (*c*) the *double declining balance.* The additional depreciation which would be allowed by this bill is always applied to reduce the taxpayer's overall basis or cost for depreciation purposes. However, the additional depreciation allowed is not charged to the declining balance under the *double declining balance method* in order to reflect more nearly the same proportionate increase as in the case of the other methods.

A comparison of the depreciation allowable under existing law for an asset having a useful life of 10 years and the depreciation which would be allowable if this amendment were adopted, is shown on the following schedule:

DEPRECIATION DEDUCTIONS—COMPARISON

10-year asset, cost $1,000 (assuming no salvage value)

Year	Straight line		Sum of years digits		Double declining balance	
	Existing law	Proposed amendment	Existing law	Proposed amendment	Existing law	Proposed amendment
1	100	120	182	218	200	240
2	100	120	164	197	160	192
3	100	120	145	174	128	154
4	100	120	127	152	102	122
5	100	120	109	131	82	98
6	100	120	91	109	66	79
7	100	120	73	19	52	62
8	100	120	55	------------	42	50
9	100	40	36	------------	34	3
10	100	------------	18	------------	27	------------

Under the amendment a taxpayer may elect to claim the increased depreciation deductions with respect to all or any part of his eligible assets. He may elect to take the additional deduction in 1 year, fail to elect it for the next year, and then elect it again later on for subsequent years with respect to the same eligible assets. The additional depreciation deductions need not be elected by the taxpayer for the first year in which depreciation is claimed with respect to an eligible asset. The amendment will not increase a taxpayer's total depreciation deductions with respect to an asset over the asset's useful life.

NEED FOR ADDITIONAL DEPRECIATION RECOGNIZED

It is recognized by the majority of the committee and by the Treasury that American industry is currently at a disadvantage with its European competition in the writeoff of machinery and equipment.

The Secretary of the Treasury submitted to the committee an analysis of the depreciation deductions and similar allowances for

industrial equipment in the leading industrial countries compared with similar deductions and allowances in the United States. The Treasury analysis of depreciation disclosed that the average Italian manufacturer is permitted to write off 100 percent of the cost of his equipment in the first 5 years; the average German manufacturer is permitted to write off 67.2 percent in the same period; Japan and the other industrialized countries permit writeoffs ranging from 64 to 100 percent in the first 5 years. The same American manufacturer would not be permitted to write off as much as 50 percent of the cost of his equipment in the first 5 years.

The Kennedy administration thus acknowledges that the depreciation allowances under existing law are inadequate. The Secretary has also acknowledged that the revision of Bulletin F *alone* will not be sufficient. If American industry is to replace its equipment more rapidly, the Congress must liberalize our depreciation policies by providing for an acceleration in the earlier years. In advancing the investment credit proposal, the administration is willing to forego between $1.8 and $2 billion in revenues for this purpose. The revenue loss could be better used *in part* to give business the type of depreciation which the Treasury admits business will need in the competitive times ahead. On the other hand, the depreciation substitute which we propose is timed so as not to create a Federal deficit. The revenue loss for the first full fiscal year (1964) will be about $485 million. This will increase to about $815 million in the next year as more assets qualify for additional depreciation. Accordingly, the revenue loss will be less than one-half of the cost of the investment credit. Industry and labor have both testified to the fact that the investment credit approach is unsound. In view of the revenue effect *alone*, there is no reason why the Congress should not *in fairness to American industry and to the American taxpayer adopt the depreciation amendment* and give industry the type of tax reform which is needed.

DEPRECIATION PROPOSAL AVOIDS "LOOPHOLES" IN INVESTMENT CREDIT APPROACH

Under the investment credit approach the taxpayer is granted a subsidy for the purchase of specific types of property. The taxpayer is then permitted under the law to recover through depreciation the *full cost* of such property, including the amount subsidized through the investment credit. The taxpayer will thus obtain *both* a tax credit or subsidy *and* a tax deduction for the same expenditure. This obvious "loophole" is avoided in the depreciation proposal, because the taxpayer still will not be permitted to recover through depreciation more than 100 percent of the cost of the property.

The depreciation proposal likewise avoids the "loophole" in the investment credit approach as applied to Government contractors and subcontractors. Depreciation is reflected in the accounting for renegotiation, cost-plus-fixed-fee contracts, or redeterminable price contracts. The taxpayer does not realize any "windfall" because the taxpayer only recovers for actual expenditures.

Similarly, the depreciation approach avoids the problem of the lessor-lessee relationship which is inherent in the investment credit. The lessee does not get a depreciation deduction with respect to leased property. The lessor's depreciation would necessarily bear some rela-

tionship to the rentals received from the lessee. As distinguished from the investment credit, there is no "under the table" bonus to be traded between the lessor and the lessee.

Discussion of Inventory Amendment

general explanation

In providing accelerated depreciation, the proposed amendment meets the needs of the manufacturing or productive segment of the economy in which there must be a relatively large investment in depreciable personal property such as machinery and equipment. However, the products of those industries cannot be sold to the consumer without the distributing and retailing segment of the economy. There are more than 1½ million "small merchants" who must stock the increased output of industry if the goods are to be sold. The inventory amendment is intended to facilitate the carrying of that stock.

The small merchant frequently is unable to set aside, after taxes, sufficient income to carry the necessary increases in his inventory which may be required either because of inflation, the introduction of new products, or normal growth. If these merchants are to compete with the large merchandising chains, some form of tax relief is necessary. The inventory amendment will permit the taxpayer to reduce the cost of his inventory by 20 percent of the first $100,000 of inventory valuation, computed without regard to this section, with the limitation that the inventory adjustment cannot exceed 50 percent of taxable income.

The working of the amendment may be exemplified, as follows:

> Assume that the taxpayer, an independent furniture dealer with a closing inventory of $80,000, had net income of $23,000. His adjustment for the first year under this section would be $11,500 (the lesser of 20/100×$80,000 or 50/100×$23,000). The taxpayer's taxable income would thus be $11,500. In the second year, assume that the taxpayer's closing inventory was $100,000, and his taxable income was $30,000, both before adjustment under this section. His adjusted closing inventory would be $85,000 and his adjusted income would be $15,000. In this example as compared with existing law, the amount deferred in the second year was only $3,500 because the cost of goods automatically reflected the prior year's adjustment. The net effect would be to allow the taxpayer an additional deduction because of the "growth" in his inventory.

The provision for the inventory adjustment was limited to the first $100,000 in inventory because numerically more than 95 percent of taxpayers in the distribution and retail businesses have sales with less than $1 million per year. Such taxpayers would not normally have inventory in excess of $100,000.

inventory amendment provides "equitable" adjustment

The inequity of taxing income from the sale of property, where such property is replaced with similar property at a higher cost, has long been recognized. For example, if a television dealer has an inventory of 12 television sets costing $1,000, and sells those sets at

retail during the taxable year for $1,500, the dealer has realized a gross profit of $500. However, in order to stay in business, the dealer must replenish his stock. If he buys 12 similar television sets at a cost of $1,100, his actual gross profit is only $400.

Section 472 of the Internal Revenue Code provides for an elective inventory costing formula (LIFO) which permits the dealer to use replacement cost as the cost of the goods sold. However, the small wholesaler or retailer frequently cannot readily adopt this method of valuing inventories. Section 472 may be too complicated for the small merchant, or the benefits may not justify the cost of accounting on this basis. Whatever the reason, LIFO is rarely used by the smaller businesses.

The proposed amendment will extend a privilege to the smaller businesses, similar to the LIFO formula, for a percentage writedown of the closing inventory which results from costing the goods sold on a first-in, first-out basis. The amendment will not apply in the case of a taxpayer who uses the LIFO formula in valuing inventories since that formula by itself grants some relief against the effects of inflation.

INVENTORY ADJUSTMENT IS TAX DEFERRAL—NOT TAX FORGIVENESS

Since the reduction of the closing inventory value will have the effect of deferring—not exempting—from tax the amount by which the taxable income is so reduced, the inventory adjustment is at the election of the taxpayer. If the taxpayer elects to reduce the closing inventory value, the amount of reduction will automatically be reflected in the opening inventory of the following year, and to continue the deferral of tax the closing inventory of subsequent years (first computed as if the election had never been made) will be similarly reduced unless the taxpayer elects to terminate the election. If the taxpayer terminates his election, the closing inventory for that year is computed as if the election had never been made, with the result that the amounts previously deferred through the inventory reductions are included in taxable income.

The provision will result in an aggregate revenue loss of about $1.1 billion, which will be spread over three fiscal years as taxpayers exercise the option to take the deduction in the first taxable year that the taxpayers qualify for the deduction. Thereafter, the revenue loss is limited to the net increase in inventories. As inventories fluctuate from year to year, there is no certainty that there will be a continuing revenue loss from this provision.

Discussion of Withholding on Interest and Dividends

GENERAL

Withholding on interest and dividends attacks the foundation on which the American tax system has produced more revenue voluntarily, notwithstanding excessively high rates, with greater compliance, than any other revenue system in history. Our tax system has derived its strength from the principle of voluntary self-assessment. The withholding provision would seek to destroy this.

Withholding on interest and dividends is an administrative monstrosity. Such withholding will not, and cannot, be handled in the

same manner as withholding on wages and salaries. After extensive hearings, it was apparent to the committee that any procedure for withholding on interest and dividends would result in either (1) massive overwithholding due to the nonrecognition of exemptions, exclusions, and deductions, or (2) administrative chaos if an effort were made to predicate such withholding upon the individual's actual tax liability. The plan finally approved by a majority of the committee, at the "last minute," attempts to straddle the issue. It will produce both massive overwithholding and administrative chaos.

It has been frequently stated that "since there is withholding on salaries and wages, there should also be withholding on interest and dividends." This is a specious argument. In the case of withholding on salaries and wages, there is only one employer-employee relationship at any one time during the taxable year. The employee is permitted to claim any exemptions to which he might be entitled. The rate of withholding on the employee is supposed to take into account his normal deductions. Every effort has been made to be certain that there is no "overwithholding." Even with these safeguards, the Treasury processes more than 40 million refund claims annually resulting from "overwithholding" on salaries and wages.

For millions of small depositors, investors, cooperative patrons, and the like, any withholding means overwithholding. In fact, a withholding rate of 20 percent is higher than the average effective tax rate for most recipients of interest and dividends.

BILL WILL PRODUCE MASSIVE OVERWITHHOLDING

In a statement as recent as January 25, 1962, the Commissioner of Internal Revenue estimated that there were more than 350 million interest and dividend accounts which would be affected by withholding if applied only to payments of $10 or more. If we add to this number all the other holders of Federal savings bonds, the patrons of the cooperatives, those receiving interest or dividends from insurance companies, to mention only a few, where the amount subject to withholding would be less than $10, the total number of accounts becomes astronomical—at the very least there will be 500 million accounts subject to withholding. Exemption certificates must be filed for all of these accounts—*each calendar year except where based on age* (under 18) or withholding will apply.

The provision for an exemption certificate will only be available to a very small number of these individuals. In order to give an exemption certificate, the individual must certify "that he reasonably believes that he will not * * * be liable for the payment of any tax," after the allowance of certain credits. None of the individual's exemptions or deductions are taken into account in determining how much of the individual's income, otherwise subject to this withholding, will be subject to any tax. Unless the individual *"reasonably believes" that he will be able at the end of the tax year to file a return showing absolutely no tax liability whatsoever, the individual cannot give an exemption certificate.* The possibility that an individual might owe $1 in tax subjects that individual to withholding at a rate of 20 percent on all of the individual's income from interest, dividends, and the like.

Furthermore, while there are procedures for quarterly refunds, an individual cannot file such a claim if his gross income for the taxable

year will exceed $5,000, if single, or will exceed $10,000, if married or the head of household. Thus, it would be a cruel deception to assure any of these many millions of individuals that the withholding contemplated by this bill contains any exemption, or refund procedure, which would assure them of not being deprived of 20 percent of their interest and dividend income even though no tax might be due on such income.

If withholding on salaries and wages where the taxpayer is given the benefit of all of his exemptions, together with an effective rate which reflects the standard deduction, produced more than 40 million cases of overwithholding, the number of cases which will be produced by this bill defies imagination. The Treasury would be inundated by claims for refund, if all of these individuals were permitted to file a claim whenever an amount had been withheld which was not due. Obviously, the Treasury recognizes that many of these individuals will forget or not go to the trouble and expense of filing a claim for a nominal amount. Since no record will be kept by anyone else, the majority is placing this burden on the individual with the expectation and hope on the part of the Treasury that the individual will be practical and not bother with nominal amounts.

PROPER WITHHOLDING PROCEDURES ARE NOT CONTEMPLATED

The basic distinction between withholding on interest and dividends and withholding on salaries and wages was recognized when the Kennedy administration first proposed the former. In the President's recommendations on tax revision, the following was proposed:

> The proposal provides for withholding of income tax on interest and dividend payments at source. It is a simple and fair system. It would minimize the additional work of interest and dividend payers. No withholding receipts for payees would be required. No payer records of withheld tax by individual payee would be required. There would be no exemption of payees from withholding. *As a consequence, across-the-board withholding would necessarily involve overwithholding on payments made to tax-exempt organizations and to certain individuals.* The proposal, however, provides corrective devices to accelerate recovery of such overwithheld amounts (Hearings before the Committee on Ways and Means, 87th Cong., 1st sess., on "The Tax Recommendations of the President," Apr. 20, 1961, vol. 1, p. 272). [Italics supplied.]

The reasons for the "no exemption" rule, undesirable as it might be, was stated to be that any attempt to maintain individual withholding accounts either by the Treasury or by the payers would more than offset the supposed advantages of withholding. Accordingly, the statement continues:

> Withholding agents would withhold at 20 percent from all interest and dividend payments subject to withholding. The agent would not be required to keep records of tax withheld from each recipient, nor would the agent be required to provide withholding receipts to the recipients. The withholding agent would merely remit to the Internal Revenue

Service 20 percent of the total interest or dividends payable (ibid., p. 273).

In recognition of the massive overwithholding which would result from this proposal, the majority of the committee were not willing to approve a "no exemption" approach to withholding on interest and dividends. In fact, the exemption provision in this bill for individuals 18 years of age and over is identical in terms to the provision in the discussion draft of August 1961. It was opposed by the Treasury because of the resulting confusion which such a procedure would create. For that reason, the majority first proposed to limit the exemption certificate to individuals 65 years of age and over. It was opened up to all individuals when it became obvious that this would still leave a large group subject to withholding for a tax which was not, in fact, owing to the Government.

Nevertheless, the bill does not provide for withholding on interest and dividends analogous to the existing law with respect to salaries and wages. The taxpayer is not permitted to claim any exemptions or deductions, or to make any estimate of his tax, except for the "pauper's oath" exemption. There will be massive overwithholding.

Furthermore, under this bill the individual is not notified that any amount is withheld from his interest and dividends. The withholding agent does not supply the Treasury with any list setting forth the names of the individuals from whom taxes have been withheld, and the amount withheld as is required under wage and salary withholding. There is no procedure whereby the individual is advised as to the total amounts, or the separate amounts, which have been withheld from payments otherwise due to him. Obviously, there will be a large sum collected by the Treasury to which it has no right. No plan has been proposed to refund this sum in the absence of a claim. This feature is the real "revenue producer" in the withholding scheme.

INFORMATION RETURNS SHOULD BE SUBSTITUTED FOR WITHHOLDING

The amount of *taxable* income in the form of dividends and interest, which is not reported for tax purposes, has been greatly overstated by the Treasury. Withholding will result in depriving many people of their money who will not owe any tax. While this effect is only temporary on a single-transaction basis, it is a permanent loss on a continuing basis because notwithstanding any refund procedure, the Treasury will always have money belonging to the taxpayer.

The administration sought and Congress last year enacted legislation requiring the assignment of taxpayer identification numbers. This legislation is now being implemented. In the meantime, the Internal Revenue Service is making enormous strides in the direction of automatic data processing of tax returns. The net result of these two developments has been to make feasible the mechanical matching of tax returns with information returns (Forms 1099). All taxpayers are to be given a number. There are reporting requirements in the law whereby the companies report interest and dividends. The Treasury last year carried out a cooperative educational campaign with business. The object was to remind interest and dividend recipients of their tax obligations on such income. The Kennedy administration has again asked business and the financial industry to

conduct a similar campaign this year. This is a strange request indeed, if the administration is now convinced that last year's efforts were not effective.

In balancing the administrative problems incident to the use of information returns, as distinguished from "across the board" withholding as originally proposed by the Kennedy administration, the Commissioner of Internal Revenue in a statement before the New York Bar Association, on January 25, 1962, estimated that there would be more than 250 million information returns on interest alone even if all payments under $10 or less were exempted. The Commissioner stated:

> These are some of the "paper" consequences of the information-reporting alternative to withholding. The cost of simply processing 250 million 1099's into our ADP system, incidentally, would come to $5.5 million a year. And, after we finished the processing, the entire operation would have directly produced for us in tax not one dollar. We could, however, expect the psychological effect of broader information reporting and electronic matching to bring about some improvement in voluntary compliance.
>
> A match of the 1099's against tax returns would only *identify* the individual who apparently hadn't properly reported all dividend-interest income.
>
> It would only *show* us where the potential tax was. Information reporting and ADP obviously do not collect the tax. Further *positive* action would be required of us—through correspondence, office auditors, internal revenue agents and revenue officers.

Since the taxpayer is paying for the cost of the "ADP system," we feel that the convenience of having such a system should be passed on to the taxpayer. Otherwise, there will be withholding on the same 250 million interest payments of $10 or more, together with a much greater number of payments of less than $10, if the individuals do not, or cannot, file the "pauper's oath" type of exemption certificate.

Furthermore, withholding does not even assure that all taxes will be paid on interest and dividends. While a withholding tax may be collected from many millions of small depositors having no tax liability, there is nothing inherent in the withholding procedure to assure that the correct tax will be paid by those taxpayers who are in a higher tax bracket than the withholding rate of 20 percent. Withholding merely assures that a tax of 20 percent will be paid on all income paid in the form of interest or dividends, irrespective of whether the actual tax might be less or might be at a considerably higher rate.

The commercial banks have a total of $62 billion in deposits in 52 million separate accounts. The total interest paid on these accounts is $1.8 billion per year. In more than 80 percent of the accounts, the interest paid amounted to less than $12 per quarter. In almost two-thirds of the accounts, the interest paid, amounted to less than $12 per year. The interest paid on about 32 million of those accounts did not exceed $62 million in the aggregate. There will thus be 32 million accounts involving the withholding of less than 40 cents. Obviously, withholding is proposed with the knowledge and expectation that many of the depositors in those accounts will not undertake

to file either an exemption certificate or a claim for refund in order to recover a tax of less than 40 cents. The cost to the Government in processing a claim for 40 cents would in itself make the withholding impracticable. In effect, this is nothing more than a "nuisance" tax.

WITHHOLDING A "NUISANCE" TAX

The number of shareowners having a stake in American industry has more than doubled. More than 15 million Americans own shares in our corporations. More than 3 million of these are shareholders with low incomes, for whom the limited relief from double taxation of their savings in American industry makes their investment worth the risk. The law exempts $50 in dividends from tax. Now we are going to nullify that exemption by a withholding tax, where there may be no tax liability. Many millions of shareholders will find the filing of claims too onerous or will overlook filing claims for the refund of nominal amounts.

The savings and loan associations have a total of $68 billion in deposits, in 29 million accounts. More than 7 million depositors receive "interest" (dividends) of less than $10. The Government will unjustly enrich itself, at the expense of the small depositors, for a tax which is not due.

WITHHOLDING IS A TAX ON CHURCHES, CHARITABLE ORGANIZATIONS, AND PENSION FUNDS

According to the report of the Securities and Exchange Commission, there were approximately $30 billion assets held in pension funds which would be subject to withholding. The average return made on such funds amounted to 3.64 percent, resulting in more than $1 billion available for immediate reinvestment. Even assuming prompt quarterly refunds, under this bill approximately $54 million of the income from pension funds would be continually sterilized. There would be a permanent loss to the pension fund of this sum because of the overlapping between the time of withholding and the quarterly refund of amounts previously withheld.

In addition to pension funds, for which accurate statistics are available, there are even greater amounts invested by churches, charitable organizations, our universities, schools, and the various charitable foundations. The income from these investments, except for minor exemptions, will be subject to withholding. Through unnecessary withholding, these organizations will at all times be deprived of a part of their income. They are not subject to any tax liability either for withholding on salaries and wages, or otherwise, against which they might offset the relatively larger amount which will be withheld from them. It is difficult to understand why, if exemptions are to be granted to individuals who might have no tax liability, the same privilege should not have been extended to organizations which by law are exempt from tax. No justification for this discriminatory treatment of tax-exempt organizations was advanced by the majority during the course of the committee's consideration of the bill.

Taxation of Shareholders of "Controlled Foreign Corporation"

general

The undersigned members of the committee are unanimously opposed to the "blunderbuss" approach in the bill with respect to taxation to the shareholders of the undistributed income of a "controlled foreign corporation" (sec. 13). The allocation formula under section 482 (sec. 6 of the bill) will prevent the avoidance of U.S. taxes on income shifted to the so-called "tax haven" company. In going beyond that point, the bill is designed to penalize American business on legitimate foreign operations.

A "controlled foreign corporation" is defined in the bill as any corporation of which more than 50 percent of the voting stock is owned directly or indirectly by American taxpayers. It need not be affiliated with or a subsidiary of another American corporation. With minor exceptions, section 13 of the bill would tax to such American shareholders, whether corporate or otherwise, the earnings of the foreign corporation doing business abroad, irrespective of whether the foreign corporation distributes such income to, or has any transactions with, or ships any products to the United States. In this provision by one stroke the "new frontier" has set out to orbit the globe with our tax laws. Our revenue agents will be the "astronauts" of the future.

This unwarranted extension of our tax laws beyond our shores would be a blunder in our foreign relations far overshadowing the ill-fated Cuban invasion. It would destroy more than 15 years of effort on the part of prior administrations, both Democrat and Republican, to promote and expand the opportunity for American business in the world market as an integral part of the U.S. foreign policy. In seeking thus to stem the deficit in the balance of payments it will have the opposite effect.

tax on controlled foreign corporation unconstitutional

Section 13 of the bill has little relation to possible evasion or avoidance of U.S. tax, but is admittedly designed to reduce foreign investment. The constitutionality of this taxation of American shareholders is open to serious question. In fact, counsel for the Joint Committee on Internal Revenue Taxation has advised the committee that Congress cannot constitutionally tax shareholders on the undistributed income of foreign corporations, except in cases where such taxation is reasonably necessary to prevent evasion or avoidance of tax (Hearings before the Committee on Ways and Means, 87th Cong., 1st sess., on "The Tax Recommendations of the President," Apr. 20, 1961, vol. 1, pp. 311–313). The settlement of this question will produce long and costly litigation. Neither taxpayers nor the Government will know for years whether this unprecedented experiment in tax jurisdiction will be sustained by the courts.

reversal of u.s. foreign policy

For more than 15 years, we followed the premise that greater participation by American business in the European economy was a major objective of the U.S. foreign policy. The expansion of American business into the world markets was universally accepted as essential to

the security and survival of the free world. This policy was actively pursued by Democrat and Republican administrations alike. "Trade not Aid" was the popular slogan of the day. As a corollary to this policy, it was also recognized that the American businessman abroad must be permitted to avail himself of the same laws and customs that were available to the nationals of the other industrial nations—for it was with these other nationals that the American businessman must compete.

As recently as February 9, 1960, this committee reported out a bill entitled "Foreign Investment Incentive Act of 1960" designed to aid American business competing abroad (86th Cong., 2d sess., H.R. 5, H. Rept. 1282). The majority report contains the following statement:

> The postponement of American tax as long as the funds are used in foreign operations is necessary to place the U.S. corporations operating abroad on a competitive basis with other corporations (either U.S. or foreign owned) which operate in the same foreign countries and pay only the taxes of the foreign countries. However, by ending the deferral of U.S. tax at the time the funds are brought back for use in the domestic market or for distribution to stockholders, your committee's bill provides assurance that a tax at least equal to the full U.S. tax will be paid before the funds enter the domestic market (ibid., pp. 1–2).

As the committee pointed out in that report, the policy of not attempting to tax earnings of a foreign corporation before repatriation had long been recognized as essential to supplement the U.S. foreign policy as well as to enable American-owned corporations to meet their foreign competitors on an equal basis. The majority report further stated:

> The need for deferring the imposition of U.S. tax in the case of domestic corporations has long been recognized. It was advocated by the State Department as a part of the point 4 program in a publication issued in 1949. It also was advocated by the President in his budget message in 1954. At that time tax deferral was provided for in legislation passed by the House but was not finally enacted. More recently tax deferral for foreign income has been advocated in two reports published in 1959 under the auspices of the administration. It has also been advocated in testimony before your committee by representatives of the Treasury Department for use in the less developed countries—the countries where, because their tax rates generally are lower, deferral of U.S. tax has its greatest impact (ibid., p. 2).

Section 13 of the bill is a complete reversal of the policy recognized and approved by this committee in that report—not because the policy was not effective—on the contrary, it can be said that the concern of the Treasury stems from the fact that the policy succeeded. Western Europe was transformed from a debtor to a creditor of the United States. The policy was, and still is, sound. Section 13 of the bill contradicts that policy. It is advanced by the majority, in part

at least, as a means of improving our balance of payments. It will have the opposite effect.

In the long run, foreign investment is helpful to the balance of payments, because a dollar invested abroad increases exports from the United States and produces dividends to the American investor which ultimately exceed the dollar invested. This fact is not disputed.

CONTROLLED FOREIGN CORPORATION TAX IS "ISOLATIONISM" AT ITS WORST

The argument was made that existing laws with respect to taxing of foreign income encouraged the "exportation of jobs." Therefore, the bill proposes to penalize American business operating in the more developed countries. This argument is premised upon the fallacious assumption that American business goes abroad to avoid U.S. taxes.

In the past decade there has been a considerable movement of business from the heavily industrialized States such as the New England States, Michigan, Pennsylvania, Ohio, and New York, to the less industrialized Southern States such as Arkansas, the Carolinas, Virginia, Alabama, Georgia, and Mississippi. Members of the Congress from the States gaining new industries as well as the States losing old industries, well know that Federal taxes obviously had no part in bringing about this movement.

Any attempt to keep American business at home through the tax laws is "isolationism" at its worst. The tax laws would then become the equivalent of a discriminatory tariff or duty, applicable only to the American-owned business operating overseas but not to its foreign-owned competitor. There is no evidence that industries have "exported jobs" to the more developed countries. In a few instances, perhaps, American-based companies established foreign plants to produce goods for the American market when they could no longer compete with foreign imports. However, this is the exception. Until such time as the Congress can be assured that American-made products can be freely traded in the European market, it would be a great mistake to penalize the American businessman for going abroad in order to make his place in that market.

The administration purports to seek "equity" between U.S. firms operating abroad and competing firms located in the United States. This fallacious reasoning completely ignores the fact that American-owned foreign corporations must compete in a foreign country with foreign corporations which are foreign owned. The American-owned foreign corporation can successfully meet this competition only so long as it is able to operate under the same rules as its foreign competitor. If the American firm cannot invest abroad, foreign capital will take its place. The income flowing back to the American investor will be less and our balance of payments will be adversely affected.

Of the 14 major industrial nations, there is not one which taxes undistributed earnings of nonresident foreign subsidiaries. Seven of our major competitors (Australia, Belgium, Canada, Denmark, France, Norway, Switzerland) have adopted tax incentives to boost foreign investment by eliminating or reducing taxes on dividends from foreign subsidiaries. Most Latin countries have eliminated taxes on dividends from foreign subsidiaries. In the United Kingdom,

an overseas trading corporation even though organized and managed locally, can do business abroad and pay no United Kingdom tax until a dividend is paid. It is the companies of these countries which form the competition. They include such names as Mitsui, Mitsubishai, Krupp, Bayer, Hoechst, Unilever, Shell, SKF, Imperial Chemicals Industries, Montecatini, Pirelli, Michelin, British Motor Corp., Renault, Societe Generale, and a host of others. Thev are aggressive, skillful, progressive, and well financed. The bill will put an almost unbearable strain on the ability of American-owned foreign subsidiaries to compete with those foreign companies.

The real purpose of this part of the bill is to prevent American business from operating in the world market—an astounding proposition in view of the Kennedy administration's trade program. When taken together, the administration would invite the foreign-owned producer to come in duty free, while locking his American-owned competitor in the closet.

THE AVOIDANCE OF FOREIGN TAXES IS NOT A "LOOPHOLE"

The earnings of foreign corporations operating abroad are subjected to U.S. income tax when distributed to U.S. shareholders. That is the generally accepted rule with respect to all corporations, both foreign and domestic. Neither the United States nor any other major country has attempted to tax the earnings of a foreign corporation not doing business within its jurisdiction unless and until those earnings become available to the shareholders over whom the taxing authority has jurisdiction. Our many tax treaties are based upon this principle of law.

The use of a so-called "tax haven" company to minimize taxes in foreign countries on transactions emanating from those countries is a practice common to foreign-owned corporations as well as American-owned corporations. If West Germany, for example, is willing to permit such a practice on the part of German corporations, there is no reason why the United States should place its nationals at a disadvantage in competing in the world market with products manufactured by German-owned German corporations.

The use of a so-called tax haven to insulate profits for operations which take place wholly outside of the United States is not a "loophole" in the U.S. tax laws. There is no justification for taxing income earned by a foreign corporation on transactions occurring outside of the United States merely because of American shareholders. Until the foreign corporation distributes that income, the American shareholders have not realized any income on which a tax can be levied.

Any effort to avoid U.S. taxes by means of fictitious exchange prices can be covered under section 482. More frequently, the intermediate corporation is used to avoid foreign income taxes in the country of ultimate destination. This should not be of concern to the United States.

TAXATION OF FOREIGN INCOME SELF-DEFEATING

The use of a so-called "tax haven" by an American-owned foreign company to minimize the impact of foreign taxes produces more tax revenue for the United States. The corporate tax rates in the major European countries are about the same as the U.S. rate. When

funds are repatriated directly from those countries, there is no U.S. tax because of the effect of the foreign tax credit. However, if the American-owned foreign company can minimize the impact of these foreign taxes, the available foreign tax credit will be reduced, and the ultimate tax paid to the United States will be increased. The U.S. tax will yield more, not less, revenue because of the use of a so-called "tax haven" company.

Other foreign countries may increase their tax on the export companies in order to soak up the differential in tax which would otherwise go to the United States. In that event, the sole result of the provision will be to handicap American business, with no additional tax revenue to the United States. From any aspect, the provision is self-defeating.

The bill is thus more likely to increase the tax revenue of foreign countries than to bring in additional U.S. tax. The provision attacking "export sales" from one foreign country to another are aimed at situations where the only tax which can be considered to be avoided is that of a foreign country. The provision seems to be designed to force incorporation in the country of destination of the goods, rather than to produce any actual revenue. This provision even handicaps exports from the United States by foreign subsidiaries buying at legitimate prices from their domestic affiliates. Some of the underdeveloped consuming countries do not have laws under which local incorporation can satisfactorily be accomplished.

The "export sales" concept appears to be primarily directed at the so-called tax haven marketing companies incorporated in Switzerland and other "low-tax" countries. U.S. taxation of the income of American-controlled Swiss marketing companies will only drive American business out of the European market. The network of tax treaties between European countries and the favorable treatment which some of them, regardless of treaties, afford to dividends from foreign subsidiaries (e.g., Belgium, the Netherlands, Norway, and France, as well as Canada and Australia) fosters the use of Swiss marketing subsidiaries by the principal competitors of American business, and gives them tax advantages over American business even under the present U.S. tax law, without the added burden of this bill.

PROVISION CREATES CONFUSION AND DISCORD

Section 13 of the bill will create staggering administrative difficulties for the Treasury and place great accounting burdens on taxpayers. Accounting methods in foreign countries, both for tax and corporate purposes, differ from U.S. tax accounting, which must be applied under the bill. Is the Treasury prepared to accept returns without examination of these problems, or does it plan to send swarms of agents all over the world? If the latter, will the effect of their expenses abroad on the balance of payments be less than whatever additional inward remittances may actually be produced by the bill? The amendment to section 482 contained in the bill will defeat the only type of real U.S. tax avoidance which could be charged against the use of foreign corporations. The Treasury advocated this as a solution of administrative burdens with which its present staff could not cope. Relief from that problem will certainly not free enough Treasury employees to handle the Pandora's box of problems which

will be opened by this attempt to give worldwide application to the U.S. law.

Where, as is becoming more and more the case, a substantial stock interest in a "controlled foreign corporation" is held by foreign nationals, conflicts will arise as to operating and dividend policies between them and the U.S. shareholders. The foreign shareholders will not be interested in reorganizing corporate structures or in changing methods of operations to comply with the patterns which the bill seeks to dictate. They will not see why reinvestments should be confined to the American Government's ideas of what is to be permitted. Finally, if the American shareholders are to be taxed, they will want dividends of at least enough to pay the tax, and such distributions may conflict with the plans and interests of the foreign shareholders.

The policy of the bill may conflict with foreign legal requirements as to the establishment of reserves or with other limitations on distribution of earnings. Foreign governments will resent and resist intervention by U.S. law into the internal affairs of corporations existing under their laws, especially when partly owned by their nationals.

The bill leaves the designation of so-called "less developed" countries to the discretion of the President, uncontrolled except for a list of 20 countries which cannot be designated. Mere failure to issue the required Executive order will prevent the most primitive areas in the world from being recognized. American businessmen will not know from year to year what areas will qualify. They will be at the mercy of changing Executive opinions as to the areas of the world which should be relieved from the handicaps on reinvestment provided by the bill. Legitimate plans for the operation and expansion of a business in such a country, made when a favorable Executive order was in effect, can be upset by its later revocation.

CONTROLLED FOREIGN CORPORATION TAX VIOLATES TAX TREATIES

As recently as March 8, 1961, the Committee on Foreign Relations of the Senate reported for ratification the Convention of the Organization for Economic Cooperation and Development, together with two protocols relating thereto signed in Paris December 14, 1960 (87th Cong., 1st sess., Senate Executive Report 1). The Organization of Economic Cooperation and Development (OECD) superseded the Organization for European Economic Cooperation. A fiscal committee composed of representatives of the 18 member states, including representatives of the U.S. Treasury, prepared articles to be included in a draft convention for the avoidance of double taxation with respect to tax on income and capital. The Council of the OECD recommended that the member states adopt those articles in existing conventions and in negotiating future conventions. These recommendations became binding upon the United States as a member of the OECD.

The United States has income tax conventions with 14 of the 19 present members of the OECD, i.e., Sweden, the United Kingdom, Germany, France, Netherlands, Denmark, Norway, Switzerland, Austria, Italy, Belgium, Greece, Ireland, and Canada. All of these conventions are predicated upon respect by the United States for the existence of a corporation of the other contracting states as a legal entity with a jurisdictional personality distinct from its American and

other shareholders. Consequently, the American shareholder as well as other shareholders are taxable only on those profits which are distributed by the company. This is clear in paragraph 5 of article XX of the convention concerning the taxation of dividends. Paragraph 5 reads as follows:

> Where a company which is a resident of a contracting state receives profits or income from the other contracting state, such other state may not levy any tax on the dividends paid by the company to persons who are not residents of that other state, *or subject the company's undistributed profits to a tax on undistributed profits*, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other state. [Italic supplied.]

In explanation, the commentary on article XX states:

> Paragraph 5 adopts a provision already contained in a number of conventions. It rules out extraterritorial taxation of dividends and further provides that nonresident companies are not to be subjected to special taxes on undistributed profits.

By becoming a member of the OECD, the United States agreed that this recommendation, in the preparation of which the U.S. Treasury participated, would apply. Thus a special tax levied on the undistributed profits of companies in other OECD countries would obviously be in contravention to the spirit of paragraph 5 even if the tax is collected solely from American shareholders.

The same is true under the U.S. tax conventions which are in force with Finland, Australia, New Zealand, Union of South Africa, Japan, Pakistan, and Honduras. The same principles are inherent in those which have been signed by Egypt, India, and Israel and are awaiting ratification.

These principles are also in the laws of all the countries of the free world with which the United States has diplomatic relations and is bound by international comity.

Conclusion

The Republican members of the committee favor sound tax reform. In fact, the only major revision of our tax laws in the last 30 years was undertaken in the Eisenhower administration, over the vehement objection of many Democratic members of the committee. Our objective in tax legislation should be to simplify, not to compound tax problems; to remove, not to add complexities to the law; and, as a bare minimum, to avoid creating any new "loopholes". This bill is a patchwork of "tax juggling" which moves in the opposite direction.

In the investment credit, the bill provides a new "loophole", which dwarfs all others by comparison. In the controlled foreign corporation tax, it provides the framework of a whole new set of tax laws which will become more complex than all existing laws dealing with the taxation of American companies. The withholding provision assures administrative chaos, attempting to reach separately more than 500 million transactions which under existing law are consolidated in the

returns of individual taxpayers. For the reasons stated in this report, we are opposed to the bill.

NOAH M. MASON.
JOHN W. BYRNES.
HOWARD H. BAKER.
THOMAS B. CURTIS.
VICTOR A. KNOX.
JAMES B. UTT.
JACKSON E. BETTS.
BRUCE ALGER.
STEVEN B. DEROUNIAN.
HERMAN T. SCHNEEBELI.

FURTHER VIEWS OF HON. THOMAS B. CURTIS

I have joined with my Republican committee colleagues in signing minority views which appear elsewhere in this report. I am opposed to the enactment of H.R. 10650 for the reasons expressed therein, and because, in my judgment, this legislative embodiment of the Treasury Department's virulent assault on American free enterprise constitutes a muddled hodgepodge of dangerously bad tax policy. The bill would make inevitable an American economic retreat at home and abroad and would increase the control of private enterprise by the heavy hand of Government bureau.

My purpose in filing these further views is to emphasize opposition to the provisions of H.R. 10650, which would impair the ability of American enterprise to compete in international commerce. These further comments will be limited to those provisions directly affecting the taxation of income from foreign sources.

I write in alarm over tax changes originally urged by the U.S. Treasury Department which in my considered judgment would subserve the aims of our enemies and would subvert the vitality of our economic endeavors both at home and abroad.

The changes included in the bill which threaten to be particularly hurtful to the American interest are:

> (1) The gross-up proposal (sec. 11): This change would require a U.S. corporate shareholder to include in its income subject to the U.S. tax the amount of foreign tax paid by a foreign subsidiary to a foreign country even though such amount of taxpayment has not been and can never be received as a dividend by the U.S. shareholder. And
>
> (2) The controlled foreign corporation tax (sec. 13): This change would provide that a U.S. shareholder owning as little as 10 percent of a so-called controlled foreign corporation (at least 50 percent American owned) would be currently taxed under U.S. tax laws on foreign earnings of the foreign corporation even though such U.S. shareholder has not received and may never receive these earnings as a dividend from the foreign corporation.

In the ensuing paragraphs I will comment on these two proposed changes by referring, first, to general criticisms that are mutually applicable to both of the changes and, secondly, to those criticisms that are peculiar to one or the other of the enumerated changes.

GENERAL CRITICISMS

These Treasury-espoused tax changes affecting foreign income threaten the ability of American private enterprise to compete and share in world trade. These changes would tax American industry and commerce on veritably phantom income—income that has never been received—under arbitrary and unprecedented tax concepts forcing a retrenchment in the role of American business in domestic and foreign trade. The resulting impairment of our contribution to free-

world strength and progress would be a major benefit to the Communist bloc. To the extent that there is a tax-induced decrease in the role of the private sector of our Nation's economy in the development of the emerging countries, there will be increased dependence on less effective government-to-government aid at a vastly greater cost to the U.S. taxpayers.

In specific reference to the impact of these unwise tax changes on the ability of American enterprise to compete in world markets, it should be realized that the proposals would seriously aggravate the tax disadvantages which are imposed even under existing U.S. tax law on American-owned foreign enterprises.

The following are offered as examples of more favorable tax treatment accorded by Common Market countries to their nationals engaged in world commerce. The Netherlands and Italy exempt all foreign income from home taxes, Belgium applies a very low rate, and France applies either a low rate or complete exemption. It should also be noted that European countries largely avoid the double taxation of corporate profits such as occurs under our tax system. Thus, it is clear that the Treasury recommendations would make the tax burden disparity against U.S. enterprise even more onerous in the world competitive markets.

Treasury Secretary Dillon, in insisting on the destructive foreign business tax rules contained in this bill, supported his position by stating before the Committee on Ways and Means that the finance ministers of the six European Common Market (EEC) countries—

> * * * informed us of their unanimous belief that the United States would be justified in discontinuing the fiscal incentives which encouraged the nonremittance of profits made in Europe.

Presumably the Treasury Secretary is more responsive to the "unanimous belief" of the Common Market finance ministers than he is to the overwhelming and substantially uncontradicted testimony in the hearings before the House Committee on Ways and Means to the effect that these proposals would be destructive of a major portion of American overseas operations.

These finance ministers urged the present administration to enact what one of my esteemed committee colleagues ably termed "Yankee, come home" laws—and this bill foolishly proposes to do just that.

The Treasury Secretary failed to inform the committee membership of a single instance of an EEC finance minister trying to have his own country impose destructive tax burdens on its national companies doing business outside of the home country. Any unwise endeavors of this sort in a EEC country would probably be recognized as cause for the removal of the erring finance minister.

Unfortunately, the benefit from the enactment of the gross-up and controlled foreign corporation proposals at the expense of American enterprise would not be restricted to European Common Market producers. The "foreign-owned" competitors of American overseas companies include the increasing economic activities under the control of Iron Curtain countries. The policies implicit in the foreign tax provisions of this bill indicate a shocking unawareness of the benefit the Communist countries would derive from curtailed American overseas economic endeavors as a consequence of added U.S.

tax encumbrances. If the Treasury foreign income tax proposals are enacted, Mr. Khrushchev will have some degree of success in making good on his promise of November 1957 to "win over the United States" in the "field of trade."

Aside from concerns over these proposals that relate to national economic goals and free world political aims, there are other basic factors that must be taken into account in evaluating the question of increasing tax burdens on American free enterprise endeavors in international trade at this time. One of the most important of these other factors is the pressing need to foster an improved equilibrium in our balance-of-payments position.

When it is considered that since World War II there has been a substantial net inflow of money into the United States from direct investment abroad, it is paradoxical that one of the main points in the Treasury argument in behalf of its proposal is the balance-of-payments problem. The implication in the Treasury position is that America should resort to a risky short-run expedient to deal with a balance-of-payments deficit, even though the long-run consequences of such an action would be to aggravate and tend to make chronic the very balance-of-payments problems that the expedient seeks temporarily to alleviate. The Treasury argument completely disregards the very substantial contribution to a favorable balance-of-payments position that is made by U.S. exports stimulated solely by American investment overseas; these are exports that make American jobs for American workers.

Another important factor that must be considered in making a judgment with respect to the Treasury foreign income proposals pertains to the benefits that are derived from American management and control of overseas operations. Because of the higher U.S. taxes relative to foreign taxes, the Treasury proposals would operate to make portfolio investment in foreign-controlled corporations more attractive and more feasible than direct U.S. ownership of a controlled corporation. To the extent that American investors shift from investment in U.S. controlled and operated foreign subsidiaries to minority positions in foreign controlled and operated companies, we would lose the export benefits we derive from American management preferences for U.S. manufactures and the advantages we derive in "know-how", patents, and secret processes. In addition, we would lose the national defense benefits from American control of foreign business activities. Also, the shift from investment in U.S.-controlled foreign subsidiaries to investments in foreign-controlled enterprises would constitute a serious blow to American persuasion and prestige in international affairs. Finally, this shift to foreign portfolio investment can only aggravate the balance-of-payments problem.

The existence of U.S.-controlled overseas companies does not result in the "export" of American jobs. The business of such a company will continue to exist abroad—either as an American-owned or a foreign-owned business. The jobs are there and they are overseas. The issue is whether the employers will be the American-controlled overseas companies or the foreign-owned competitor companies. Removing the American flag from an overseas company will not automatically remove a factory's production, or the market demand for it, from the world market. Any vacuum will be quickly filled by a

foreign-owned company. Instead of resulting in the export of jobs the U.S. control of overseas companies accounts for substantial merchandise exports to, or developed by, U.S. foreign subsidiary companies. According to data submitted to the committee on Ways and Means by the Department of Commerce and appearing on page 430 of the 1961 hearings on the administration's tax recommendations, such American exports with respect to U.S.-controlled foreign subsidiaries amounted to $2.2 billion in 1959 and $2.7 billion in 1960.

The foregoing has represented a discussion of some of the considerations and consequences that attend both the gross-up and the controlled foreign corporation recommendations of the Treasury Department as approved by the committee majority. I will next briefly comment on some of the pertinent factors that bear primarily on one or the other of these proposed tax changes.

CRITICISM OF THE GROSS-UP PROPOSAL

In evaluating the gross-up concept it should be remembered that it involves the imposition of a U.S. tax on an amount paid as foreign tax to a foreign country by a foreign corporation on foreign income and that the hapless U.S. taxpayer has not received the amount and can never receive the amount to which the U.S. tax is applied. Thus, it is an actual tax applied to nonexistent income.

The only basis on which the validity of the gross-up can be argued is the superficial contention of "equal" tax treatment predicated on an arithmetical concept that cannot stand up under the overwhelming persuasion of the substantive factors militating against the gross-up. Examples of such substantive considerations are—

(1) The gross-up does not "equalize" the tax treatment between foreign branch and foreign subsidiary operations nor does it "equalize" the risks involved in foreign and domestic investment. Foreign branch operations give rise to many tax benefits not available to foreign subsidiaries. The "equality" argument also fails to recognize the greater risks attending foreign investment involving less stable economies, foreign exchange problems, political uncertainties, and expropriation dangers.

(2) The argument for the gross-up based on a concept of arithmetical nicety completely overlooks the fact that the foreign tax credit is admittedly not a precise measurement of foreign taxes paid and does not allow an offset for the many foreign taxes not based on an income tax concept—such as turnover taxes, net worth taxes, capital stock taxes, property taxes, etc.—which frequently comprise the major revenue and tax burden factors in a foreign country.

(3) The gross-up ignores the economic reality of bitterly contested competition in the marketplaces of the world, and goes in the face of the unrefuted testimony presented to the committee in public hearings last spring that the gross-up would seriously aggravate the existing tax disparity against U.S. industry and make it more difficult for American business to survive and compete in international trade.

(4) The principal tax impact of the gross-up in terms of increased tax burdens on American economic endeavors would be with respect to activity in the so-called developing or emerging nations, including the Latin American countries. Thus, the

gross-up would be inconsistent with our announced foreign policy objectives and would markedly encumber the contribution of private enterprise to the realization of the goals outlined in the alliance for progress. It would also tend to be inconsistent with the foreign trade policy objectives recently enunciated by the President.

(5) The gross-up would be violative of 13 existing tax treaties under which the United States has obligated itself to tax the return on investments in these countries only in accordance with the tax credit formulas in effect at the times the treaties were negotiated. It is to be regretted that the views of the State Department on this point of treaty violation were not made available to the Committee on Ways and Means and to the House.

(6) The gross-up would change the tax rules applicable to income derived from foreign operations after American enterprise had committed literally billions of dollars in overseas investment at the urging of deliberate U.S. Government policy over many, many years.

Thus, the gross-up proposal as contained in H.R. 10650 is fallacious in principle, inequitable in result, violative of treaty obligations, and dangerous in its economic implications with respect to America's role in international trade.

CRITICISM OF THE CONTROLLED FOREIGN CORPORATION PROPOSAL

Of the many provisions of H.R. 10650 that would operate to destroy American shareholder ownership of overseas subsidiary corporations, the most dangerous and far reaching is the proposal contained in section 13 of the bill dealing with so-called controlled foreign corporations.

This proposal would impose a variety of punitive new tax burdens on American shareholders holding as little as 10 percent of an overseas corporation. As has been previously explained, this tax change would impose a U.S. tax currently on U.S. shareholders with respect to income not received from a foreign corporation; income which may never be received; income which may disappear in the form of normal business losses.

An examination of the implications of the controlled foreign corporation proposal make it all too clear that the express meaning and implicit policy of the provision are—

(1) To tax currently major portions of the current income of legally independent foreign corporations; corporations whose principal offense is that they are wholly or partly American controlled and successful.

(2) To destroy effective American enterprise competitive participation in world trade at the very time the administration is urging the Congress to grant new tariff-cutting authority to the Executive exposing further our American markets to foreign-owned competitors.

(3) To make it a Federal tax offense for American interests to be other than bare minority shareholders in a foreign business. Presumably voting control would have to be surrendered to non-Americans to avoid the punitive tax rules.

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(4) To make absolutely no distinction, in deliberately intended punitive effect, between the tax-evasion-type of foreign "paper" company and the legitimate U.S. overseas business company. The tax is to be imposed on U.S. shareholders in all controlled foreign corporations.

(5) To make it a Federal tax offense for an American controlled overseas corporation which is principally engaged in manufacturing or marketing to have even a small element of income stemming from patents, copyrights, and "exclusive" processes and formulas.

(6) To use baseless tax rules to penalize American overseas companies having income in the categories of interest, dividends, or rents. For example, renting out surplus office space or plant facility is obviously good business but under this proposal it would be tantamount to attempted tax evasion.

(7) To punish U.S. shareholders of foreign corporations even through State taxation. Many States have adopted tax rules which automatically follow Federal tax law. If this punitive provision of H.R. 10650 becomes law, each U.S. shareholder in a foreign corporation must also become a taxpayer at the State level under the same weird rules because of the interrelationship of the Federal and State tax laws.

(8) To impose on the normal commercial transactions of American controlled overseas companies a myriad of artificial tax and accounting complexities, accompanied by punitive tax penaltites on U.S. shareholders for any company "transgressions" of these incomprehensible, unreal complexities.

(9) To tax currently to the U.S. shareholder the income of a foreign corporation—a tax which is clearly unconstitutional under existing decisions of the U.S. Supreme Court as shown by the opinion of the staff of the Joint Committee on Internal Revenue Taxation printed on page 311 of the House hearings. This new law is to be enacted on the curious expectation that after some years of uncertainty the Supreme Court will reverse its long-standing decisions and validate such a tax law.

(10) To deliberately, by the unilateral action of a statute, nullify, abridge and violate a great many existing income tax treaties to which the United States is a party. See, also, section 21 of the bill.

(11) To impose specific Federal tax punishment for the business offense of diversifying the overseas business operation. A simple example: It will now be a tax offense for an American controlled overseas company in the paper business to engage newly in the plastics business.

(12) Although the administration has been pushing for this tax revision for U.S.-controlled overseas corporations by saying that this is necessary to achieve "equality," "equity," and "neutrality," not a one of these desirable qualities is to be found in these provisions of the bill. A simple example: U.S. shareholders are to be currently taxed on business income of the overseas corporations, but are NOT, repeat NOT, to be allowed any deductions for losses stemming from the same businesses, nor any loss carryovers. Domestic taxpayers are allowed to deduct business losses and are allowed loss carryovers. Equity, equality,

and neutrality as to U.S.-controlled overseas companies is not extended that far under this bill.

The entire atmosphere of section 13 is that of wielding the Federal police power, using the tax system as the baton. But there is no more tax avoidance or evasion in the case of American overseas business than the small fringe that has always existed as to domestic business. The Internal Revenue Service has the tools under existing law to successfully combat any abuses.

The Treasury recommendation is blind to the fact that to the extent an American-owned foreign subsidiary can operate abroad in a way to reduce the taxes paid to foreign countries, the tax money saved is largely saved for the U.S. Treasury. It seems inevitable that the Treasury-proposed tax action against U.S. shareholders of controlled foreign corporations will result in increasing the foreign tax burdens imposed by foreign countries on such enterprise.

The controlled foreign corporation recommendation of the Treasury Department as provided in section 13 of the bill would largely destroy overseas subsidiary operations controlled by American shareholders with new tax rules that are akin to the type of tax sanctions used to combat tax fraud and evasion. Thus, U.S. shareholders of a controlled overseas business stand indicted of improper business practices and illegal tax policies because they successfully sought a proper role in international commerce as urged by the U.S. Government.

CONCLUSION

The Treasury proposals to change the tax rules for doing business abroad will unreasonably penalize those business entities on which America relies to perform vital and enduring foreign policy objectives. Such an approach would make U.S. business activity abroad less welcome and would encourage foreign nations to impose discriminatory taxes on foreign subsidiaries of American corporations. These consequences are contrary to our international commitments and to our national interest. The Treasury approach overlooks the fact that investment by U.S. business abroad has stimulated the purchase of goods and services from the United States and has enabled our free enterprise system to make a major contribution to America's preeminence in international affairs.

This memorandum has highlighted some of the impact that the Treasury's tax proposals affecting American foreign business endeavors will have in terms of economic consequence at home and abroad as well as pointing out some of the dangerous implications the proposals have in the area of international political affairs. Our national tax policy must not be based on unwise and unjustifiable expedients seeking a piecemeal reform of our Federal tax structure which may give rise to widespread and irreparable damage to our economic wellbeing. The excellence of our American free enterprise system and the urgent needs of our economy require that we avoid tinkering with our Federal tax structure.

While in beginning these separate views it was my purpose to discuss only the gross-up and controlled foreign corporations provisions of H.R. 10650, it may be an appropriate addendum to close by observing that the entire bill is filled with definitional problems, unanswered or conflicting policy questions, and promises of litigation for years to

come. Examples of such shortcomings are found in phrases and expressions never before having meaning in tax law, uncertain definitions of property and income concepts, and the unguided delegation of authority to the Secretary or his delegate. We find in this tax bill changes in tax liability that are actually retroactive to March 1, 1913, and even before; this is the clear operative effect of section 16. We find in this tax bill—a bill being urged by the Treasury Department—a revenue loss of more than $1 billion in fiscal year 1963. We find in this bill an increase in the cost of American enterprise doing business abroad at the very time we are being urged to make it less costly for foreign producers to do business in our domestic markets.

I respectfully submit to my colleagues that unwise tax policy should not impede American free enterprise and thus radically cut down the American share of world commerce for which Iron Curtain countries compete.

There are many reasons why H.R. 10650 should be defeated; the poorly thought out foreign income proposals are important among those reasons.

THOMAS B. CURTIS.

REVENUE ACT OF 1962

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[H.R. 10650] [1]

REVENUE ACT OF 1962

[Senate Report No. 1881, Eighty-seventh Congress, Second Session, Calendar No. 1843]

[August 16, 1962]

MR. KERR, from the Committee on Finance, submitted the following report together with individual, additional, dissenting, supplemental and minority views to accompany H.R. 10650.

The Committee on Finance, to whom was referred the bill (H.R. 10650) to amend the Internal Revenue Code of 1954 to provide a credit for investment in certain depreciable property, to eliminate certain defects and inequities, and for other purposes, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

I. GENERAL STATEMENT

This bill, H.R. 10650, represents a major revision and reform of our Federal tax system. This is a matter which has been under consideration by Congress since April 20, 1961, when the President sent up his tax message. Most of his recommendations, modified as the House and your committee believe desirable, are incorporated in the amended bill reported by your committee.

The bill contains three principal groupings of tax revision measures. The central element in the bill is the investment credit. This allows a 7-percent credit against tax for most taxpayers for their purchases of machinery and equipment and certain other property (not including buildings). This investment credit, coupled with the depreciation guidelines recently liberalized by the administration, by stimulating capital formation will provide growth in the economy consistent with the principles of a free economy. This investment credit, by encouraging the modernization and expanded use of capital equipment, will improve our competitive position abroad and thus aid in meeting the balance-of-payments problem. Moreover, the capital formation

[1] Public Law 87-834, page 111, this Bulletin.

induced by this credit will both aid in providing the longrun growth needed by our domestic economy and be of major assistance in our more immediate problem of economic recovery.

The remaining provisions in the bill are concerned primarily with improving tax equity and eliminating tax evasion or avoidance, either in the domestic economy or with respect to income earned abroad by American interests. In the latter case, the primary concern of your committee has been with the removal of special tax advantages accruing to "tax havens."

One of the measures in the House bill, designed to decrease tax evasion (whether or not deliberate) was a provision for withholding on dividends, interest, and patronage dividends. Because of both the burden of such a provision on individuals owing little or no tax and its many complexities, your committee has deleted it, but has added a requirement for the reporting of payments of dividends, interest, and patronage dividends exceeding $10 annually per recipient, both to the Government and to the recipient. Your committee believes that in the long run this will have at least as great an impact on tax evasion as a withholding system.

Both the bill as passed by the House and as amended by your committee reduce tax avoidance by providing ordinary income treatment for gains from the sale of depreciable property to the extent of depreciation taken. Moreover, by preventing the conversion of ordinary income into capital gains this has been an important factor in making the new liberalized depreciation guidelines feasible.

Among the more publicized and troublesome problems with which the bill is concerned is the deduction for entertainment expenses. Your committee believes that its version of this provision provides a balanced approach which neither prevents deductions for legitimate entertainment expenditures nor permits them for the continuation of abuse situations.

Your committee's bill also is concerned with competitive advantages of specific groups of taxpayers. In this regard your committee, in general agreement with the House, concluded that the reserve deductions of mutual savings banks and savings and loan associations are too large and should be reduced, that mutual insurance companies should be taxed not only on investment income but on their underwriting gains as well, and that in the case of cooperatives a full tax should be paid currently at either the level of the cooperative or at that of the patron.

In the case of foreign income, your committee has been primarily concerned with ending tax haven abuses; namely, devices to avoid either the United States or foreign taxes which could be expected to be imposed under normal business operating conditions. To achieve this goal the bill ends the deferral of the U.S. tax in the case of certain forms of income arising from insurance abroad of U.S. risks, from passive investments, from sales and service subsidiaries separately incorporated from the producing companies, and from funds which are brought back to this country without the payment of U.S. tax. A number of other measures dealing with foreign income or property are also included. Provision is made for the payment of a full 52-percent tax through a "gross-up" procedure when income is brought back to the United States from a foreign subsidiary; for the taxation of income at ordinary income tax rates when controlled foreign corpo-

rations are liquidated or the stock interests sold; and for the full taxation by the United States of income distributed to American beneficiaries by foreign trusts set up by American grantors. In addition, a ceiling has been placed on the earned income exclusion for Americans who are residents abroad; and foreign real property holdings are to be included in the estate tax base of U.S. citizens.

Your committee began hearings on this bill on April 2 of this year. These hearings extended until July 3 and included 29 days on which testimony was heard. This material is contained in 12 volumes of nearly 5,000 printed pages. In addition, your committee has considered this bill in executive session for a period of several weeks. The bill, therefore, represents decisions reached by your committee after careful deliberation over an extended period of time.

A. Summary

The provisions contained in the bill as amended by your committee can be summarized by section numbers as follows:

(1) The act is to be cited as the "Revenue Act of 1962."

(2) An investment credit against tax liability is provided. Generally it is 7 percent of investments in new tangible personal property and certain other depreciable property, excluding buildings. A credit also is available for limited amounts of investments in used property. The taxpayer's depreciation base for tax purposes is to be reduced by the amount of the investment credit.

(3) A deduction is provided for expenses relating to appearances before, and communications with, a legislative body, a legislative committee or individual legislator, if the expenses are otherwise ordinary and necessary business expenses. Also included are expenses of communications between an organization and its members and between a business and its employees or stockholders. This provision does not cover advertising expenses or those concerned with political campaigns.

(4) Deductible expenses for entertainment, amusement or recreation generally are limited to those directly related to, or associated with, the active conduct of a trade or business. In the case of expenses related to facilities, to be deductible they must also be used primarily for the furtherance of the taxpayer's trade or business. Limitations are provided in the case of traveling expenses and business gifts. In addition, rules are set forth providing that deduction of entertainment, etc., expenses will be denied unless substantiated.

(5) Distributions in kind from foreign corporations to corporate stockholders are treated as having a value equal to their fair market value (rather than the adjusted basis of the property), and the foreign tax credit available likewise is based on the fair market value of the property.

(6) The present tax treatment of mutual savings banks, savings and loan associations, etc., is revised so that their additions to bad debt reserves generally may not exceed 60 percent of their taxable income (before this deduction) or, if larger, an amount bringing their reserves up to 3 percent of loans on real property. Certain other limitations are also provided, and in the case of stock savings and loan associations the deduction is to be 50 percent instead of 60 percent of taxable income. In addition, a new definition of domestic savings and loan associations is provided and certain excise tax exemptions these organizations presently enjoy are removed.

(7) Distributions of accumulated income by foreign trusts, to the extent the trust was established or added to by American grantors, are to be taxed to the U.S. beneficiaries in substantially the same manner as if they had received this income directly instead of through the intermediary of a foreign trust.

(8) Mutual fire and casualty insurance companies are to be taxed on their "total" income less a deduction for loss reserves equal to one-fourth of their underwriting gain plus 1 percent of their insurance claims. Most of this reserve, to the extent not used to offset losses, at the end of 5 years is to be brought back into the company's tax base. Exemptions are provided for small companies whose total receipts do not exceed $150,000, while those whose total receipts are between $150,000 and $600,000 are taxed on investment income but not underwriting gain. The bill also deals with the special problems of reciprocal underwriters and interinsurers, of factory mutual insurance companies, of mutual marine insurance companies, and of companies whose risks such as windstorm, hail, or flood insurance are concentrated in a relatively small geographical area.

(9) Where a domestic corporation receives dividends from a foreign corporation, the amount included in its tax base, if it elects the foreign tax credit, is to be not only the dividend itself, but also the tax paid by the foreign corporation as well. This provision is not to apply with respect to dividends received from "less developed country corporations" or from certain holding companies for such corporations.

(10) The foreign tax credit limitation for certain interest income is to be computed separately from the limitation for other types of income. The interest income referred to here does not include that derived from the active conduct of a trade or business, from a banking or similar business, or from a corporation in which the taxpayer has a 10-percent voting interest.

(11) The unlimited exclusion from U.S. tax for income earned abroad by U.S. citizens who are bona fide foreign residents is reduced to $35,000 ($20,000 for the first 3 years). However, in applying this ceiling, certain fringe benefits will be gradually taken into account for purposes of this limitation over a 4-year period. In addition, the contributions which employers make hereafter toward employee pension plans, based on foreign employment, will be taxable to the employee when received.

(12) Shareholders of controlled foreign corporations are to report for tax purposes the undistributed earnings of these corporations to the extent they represent income from insuring U.S. risks, increases in earnings invested in U.S. property (generally not related to foreign business), passive investment income, and income from sales or service subsidiaries involving transactions with related persons outside of the country of incorporation of the subsidiary. Dividend and interest income derived from 10-percent-related corporations actively doing business in less developed countries and reinvested in such countries, however, is excluded from the amount taxed to the U.S. shareholders. The bill also provides that if certain minimum amounts of income are distributed (which vary in accordance with effective foreign tax rates) the shareholders are not to be taxed on the undistributed income. In addition, export trade income of "export trade corporations" within certain limits is not to be taxed to U.S. shareholders in the case of most of the categories of income described above. Other relief provisions are also provided.

(13) Any gain after 1962 on the sale of personal property and most other tangible property, other than buildings and structural components, to the extent of depreciation taken in 1962 and subsequent years, is to be treated as ordinary income for tax purposes.

(14) When stock in foreign investment companies is sold, the gain realized by U.S. shareholders is to be ordinary income to the extent of the earnings and profits accumulated since 1962. The companies and shareholders can avoid this treatment if the companies distribute currently 90 percent or more of their taxable income, other than capital gains, and the shareholders report the capital gains, whether distributed or not. In addition, until January 1, 1964, where certain conditions are met, these corporations are permitted to reincorporate as domestic corporations on a tax-free basis without obtaining prior clearance for the reorganization from the Internal Revenue Service.

(15) Where stock in a controlled foreign corporation is redeemed, such a corporation is liquidated, or the stock of such a corporation is sold, any gain realized which represents earnings and profits accumulated after 1962 is to be taxed to 10-percent-U.S.-shareholders as ordinary income. If the shareholder is an individual, his tax on this income is to be no greater than if the foreign corporation were a domestic corporation which paid the 52-percent U.S. tax (offset by any foreign tax credits) and then made a distribution of the balance to the U.S. shareholder who then is subject to a capital gains tax. (The combined tax in this case cannot exceed 64 percent.) Alternatively, the individual shareholder will not have to pay a total tax greater than the sum of the taxes he would have paid had he received the earnings and profits in the years actually earned.

(16) Gain from the sale or exchange after 1962 of a patent, invention, model or design, copyright, secret formula or process, or other similar property by a U.S. person to a foreign corporation which it controls is to be treated as ordinary income rather than capital gain. This does not apply where the transfer is to a controlled foreign corporation for use in its own manufacturing operations.

(17) Cooperatives are to receive a deduction for patronage dividends paid to the patrons in cash or by allocations if the patron has the option to redeem the allocations in cash during a 90-day period after issuance, or consents to treating this income as constructively received and reinvested in the cooperative. The patron may give his consent individually in writing, the cooperative may by its bylaws require members to give this consent, or patrons may give their consent by endorsing a check representing at least 20 percent of the total patronage dividend. For any allocation to be deductible to the cooperative, however, at least 20 percent of the patronage dividend must be paid in cash. Any of these amounts which are deductible to the cooperative must be included in the income of the patron for tax purposes when received if the amounts arise from business activity of the patron.

(18) Real estate located outside the United States, in the case of citizens or residents of the United States, is to be included in their tax base for purposes of the estate tax imposed at the time of death.

(19) Payors of interest, dividends, and patronage dividends of more than $10 per year per person must report these payments to the Government on an annual basis and also send a statement to the dividend, patronage dividend, or interest recipient indicating the annual amount so reported. Civil penalties of $10 per statement or information re-

turn are specified for each failure, other than for reasonable cause, to send the statement or information return to the recipient or to the Government. However, the aggregate penalty per payor is not to exceed $25,000 per year with respect to returns to the Government or $25,000 with respect to statements to recipients.

(20) A number of changes are made in the annual information return which domestic corporations presently are required to file with respect to foreign corporations which they control. In addition, a number of changes have been made in the return which must be filed by U.S. citizens or residents who are officers or directors of a foreign corporation and also by 5-percent shareholders of such corporations. Not only is information required to be submitted by those who are officers, directors, or 5-percent U.S. shareholders within 60 days of the organization or reorganization of the corporation but also those who presently are, or subsequently become, officers or directors or 5-percent U.S. shareholders. In the case of officers or directors, the only information required to be furnished is the names and addresses of 5-percent U.S. shareholders.

(21) In the case of farmers, expenditures incurred in the clearing of land may be deducted to the extent of $5,000 or 25 percent of the taxable income from farming for the year, whichever is the lesser.

(22) When an individual is entitled in effect to spread his income for tax purposes back over the years to which it is attributable, he may also elect to apply the 20- or 30-percent limitation on charitable contributions before the income is spread.

(23) The provision in present law which treats a husband and wife as one shareholder in the case of community property and property held as joint tenants, tenants by the entirety, or tenants in common for purposes of the election for certain small business corporations to have their income taxed directly to their shareholders is to be made effective, if the taxpayers so elect, with respect to taxable years beginning after December 31, 1957, instead of 1959.

(24) Net operating losses incurred in 1953 and 1954 by a street railway company in converting from streetcar to bus service, which are not absorbed in the normal carryover period, are to be treated as a net loss occurring in 1959. This permits these losses to be carried forward to the years 1960 through 1964.

(25) The union-negotiated pension plan of Local Union No. 435 of the International Hod Carriers' Building and Common Laborers' Union of America is to be treated as a qualified tax-exempt trust for the period from May 1, 1960, to April 20, 1961, if the trust was not operated during this period in a manner to jeopardize the interests of its beneficiaries. This also permits employers to deduct contributions made to the trust in this period.

(26) The 1939 code is amended to provide that where one partner in a two-man partnership dies, the partnership year for the surviving partner is not to close prior to the time the partnership year would have closed had neither partner died or otherwise disposed of his interest.

(27) No provision in the bill is to apply in any case where its application would be contrary to any treaty obligation of the United States.

B. Revenue estimates

1. *Estimates of the Joint Committee Staff.*—As indicated in the tables below, the staff of the Joint Committee on Internal Revenue Taxation has estimated your committee's bill will result in a revenue loss of $555 million on a full-year basis, based upon income levels for the calendar year 1962.[1] This can be compared with an estimated loss of $285 million under the House bill on a full-year basis.

For the fiscal year 1963 (July 1, 1962, to June 30, 1963, inclusive), the staff estimates that your committee's bill will result in a revenue loss of $630 million as contrasted to a loss under the House bill for that year of $1,090 million. None of these estimates takes into account any possible effect of the provisions on economic conditions. Table 1 shows the details of the staff's estimates of the effect of your committee's amendments as compared with the House bill on a full-year basis. Table 2 shows the details of the estimates for the fiscal year 1963.

As indicated in table 1, the version of the investment credit provided by your committee's amendments is expected by the staff to result in a full-year revenue loss of $1,340 million. The other provisions of the bill, on a full-year basis, are expected to raise revenues by $785 million, resulting in the net loss of $555 million. Under the House bill the full-year loss from the investment credit was $55 million more than under your committee's action. However, the additional revenue derived from the other provisions under the House bill would have amounted to $1,110 million, which accounts for the smaller revenue loss. Most of the revenue difference in these other provisions between your committee's and the House version of the bill is attributable to the substitution of reporting for withholding on dividend and interest payments. Other differences are the revenue gain from mutual savings banks, etc., under your committee's bill (largely as a result of the amendment affecting stock companies), the decreases in revenue resulting from changes made by your committee in the provisions relating to entertainment, ordinary income on depreciable property, and the "gross-up" of dividends received from foreign corporations. The entertainment provisions are somewhat less restrictive under your committee's bill than under the House bill. In the case of the provision relating to ordinary income on depreciable property the revenue loss is attributable to the change for mining companies made in the method of computing "taxable income from the property" in the case of depreciable property. In the case of the "gross-up" provision, the lesser revenue under your committee's action can be attributed to the fact that this provision is made inapplicable to income from less developed country corporations. Other provisions added by your committee also are expected to result in a $5 million revenue loss. The most significant item here is the deduction allowed farmers for clearing land. There are, of course, also differences within the various other provisions but the losses and gains involved approximately offset each other.

[1] The various provisions, of course, will not have uniform effect in future years. In the case of mutual fire and casualty insurance companies, for example, the full year revenue effect will not be reached until after an elapse of 5 years when most of what remains in the protection against loss account begins to be restored to taxable income. On the other hand, the method of charging losses in the case of dividend-paying companies may reduce tax liability in the fourth or fifth year by as much as $5 million but this will be largely offset in later years when the amounts added to this account are restored to income.

As indicated in table 2, your committee's action according to the staff's estimates results in a revenue loss of $630 million in the fiscal year as contrasted to the $1,090 million under the House bill. Most of this difference is attributable to your committee's action in making the investment credit effective only with respect to acquisitions or construction after June 30, 1962, instead of January 1, 1962, as provided by the House bill. Other differences with respect to the fiscal year 1963 estimates between your committee's action and the House bill are largely attributable to the fact that the reporting of dividends and interest is not expected to have a revenue effect until after the end of the fiscal year 1963, while part of the revenue impact from withholding would have been felt during the last half of the fiscal year 1963. The remaining difference between the two versions of the bill is attributable to the fact that the House bill would have made the entertainment provisions effective as of July 1, 1962, while under your committee's action these are not effective until January 1, 1963.

TABLE 1.—*Estimated full-year revenue effect of H.R. 10650* [1] *as passed by the House and as amended by the Senate Committee on Finance*

[Millions of dollars]

	As passed by the House	As amended by the Committee on Finance
Investment tax credit	−1,395	−1,340
Withholding on dividends and interest	+550	
Reporting of dividend and interest payments		+275
Mutual banks and savings and loan associations	[2] +170	[2] +180
Entertainment, etc., expenses	+125	+85
Capital gains on depreciable property	+110	+105
Mutual fire and casualty companies	[3] +25	[3] +25
Cooperatives	+30	+30
Foreign items:		
Controlled foreign corporations	+50	+50
Gross-up of dividends	+25	+15
All other foreign items	+25	+25
Other (secs. 21–26 of Senate Finance Committee bill)		−5
Total	−285	−555

[1] At levels of income and investment estimated for the calendar year 1962, without taking into account effect of provisions on the economy; estimates are rounded to nearest $5,000,000.

[2] The level of income for these thrift institutions in 1962 has been revised upward since the preparation of the revenue estimates for the House bill.

[3] Revenue gain which would result if this provision were in effect for 1962 and had been in effect for the 5 preceding years, so that amounts added to the protection against loss account in the first year and not offset by losses would be brought into taxable income in 1962.

Source: Staff of the Joint Committee on Internal Revenue Taxation.

TABLE 2.—*Estimated revenue effect of H.R. 10650 for the fiscal year 1963 as passed by the House and as amended by the Senate Committee on Finance*

[Millions of dollars]

	As passed by the House [1]	As amended by the Committee on Finance [1]
Investment tax credit	−1,340	−650
Withholding on dividends and interest	+170	
Reporting of dividend and interest payments		0
Mutual banks and savings and loan associations	+10	+10
Entertainment, etc., expenses	+60	+(2)
Capital gains on depreciable property	0	0
Mutual fire and casualty companies	0	0
Cooperatives	0	0
Foreign items:		
Controlled foreign corporations	0	0
Gross-up of dividends	0	0
All other foreign items	+10	+10
Other (secs. 21–26 of Senate Finance Committee bill)		−(2)
Total	−1,090	−630

[1] Estimates are rounded to nearest $5,000,000.
[2] Less than $2,500,000.

Source: Staff of the Joint Committee on Internal Revenue Taxation.

2. Estimates of the Treasury Department.—As shown in table 3, the Treasury Department has estimated that your committee's bill will result in a revenue loss of $210 million on a full-year basis, if no effect is given to the stimulative effect of the bill. With this effect taken into account the loss is expected to be only $15 million. These estimates can be compared with the Treasury Department's full-year estimates for the House bill, which show an increase in revenues of $325 million without taking into account the stimulative effect of the bill and $430 million if account is taken of this factor.

Table 3 also shows the Treasury Department's estimate of the effect of the bill in the fiscal year 1963. In that year the estimate is expected to result in a revenue decrease of $485 million without taking into account the stimulative effect of the bill and $210 million decrease with this effect. Under the House bill the estimated effect in the fiscal year 1963 would be a $325 million increase in revenues without the stimulative effect and $430 million increase with this effect.

The stimulative effect of the investment credit under the Treasury Department's estimates is based upon statistical relationships in past years between investment and gradual changes in the cost of capital goods (profit ability) and cash flow. This does not take into account the especially favorable impact on businessmen's decisions to invest or the sudden improvement in these factors resulting from the enactment of the credit.

TABLE 3.—*Estimated revenue effect of H.R. 10650 as amended by the Senate Finance Committee*

[In millions of dollars]

	As passed by House of Representatives				As amended by Senate Finance Committee			
	Full year		Fiscal year 1963		Full year		Fiscal year 1963	
	Gross	Net	Gross	Net	Gross	Net	Gross	Net
Investment tax credit [1]	−1,105	−555	−1,040	−525	−1,020	−580	−520	−235
Capital gains on depreciable property	+100	+50	--------	--------	+100	+50	--------	--------
Withholding on dividends and interest	+780	+520	+245	+235	[2]+240	[2]+155	--------	--------
Expense accounts	+125	+80	+65	+40	+60	+40	+30	+20
Mutual savings banks and savings and loan associations	+200	+135	--------	--------	+205	+140	--------	--------
Mutual fire and casualty companies	+40	+25	--------	--------	+35	+20	--------	--------
Cooperatives	+35	+25	--------	--------	+35	+25	--------	--------
Foreign items:								
Controlled foreign corporations	+85	+85	--------	--------	+85	+85	--------	--------
Gross-up of dividends	+35	+35	--------	--------	+25	+25	--------	--------
All other foreign items	+30	+30	+5	+5	+30	+30	+5	+5
Miscellaneous provisions	--------	--------	--------	--------	−5	−5	0	0
Total	+325	+430	−725	−245	−210	−15	−485	−210

[1] At levels of income and investment estimated for 1962; modified from published estimates because of current results of the Commerce-SEC survey of planned capital expenditures. In estimating the net revenue cost of the investment credit, its favorable effects on the level of investment were computed from statistical relationships in the past years between investment and gradual changes in the cost of capital goods (profitability) and cash flow. This procedure thus does not take into account the especially favorable impact on businessmen's decisions to invest, of the sudden major improvements in these factors resulting from the enactment of the credit. Taking this into account should produce more favorable effects than those shown in the table.

[2] Estimated gain from increased compliance because of reporting requirements.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Aug. 13, 1962.

II. INVESTMENT CREDIT

(Sec. 2 of the bill and secs. 38, 46–48, and 181 of the code)

A. Reasons for provision

The Secretary of the Treasury in his appearance before your committee stated:

> The central element in the bill is the tax credit for investment in depreciable machinery and equipment.

At another point he said, with respect to the investment credit:

> This matter has top priority in the agenda for tax reform. As chief financial officer of the Nation, I do not lightly regard tax abatements on the scale proposed here. I urge this legislation because it will make a real addition to growth consistent with the principles of a free economy; because it will provide substantial help in alleviating our balance-of-payments problem, both by substantially increasing the relative attractiveness of domestic as compared with foreign investment and by helping to improve the competitive position of American industry in markets at home and abroad; and because, far from adding to the forces responsible for alternative recessions and recoveries, it will be of major assistance in strengthening our present recovery and enabling us to attain a higher rate of growth

> and sustained full employment. Early action will resolve uncertainty or hesitancy and begin at once a strong and lasting incentive for modernization of the productive facilities of our national economy.

The Secretary pointed out that American industry today must compete in a world of diminishing trade barriers in which the advantages of a vast market, so long enjoyed here in the United States, are now being, or are about to be, realized by many of our foreign competitors. An increase in efficiency and productivity at a rate at least equal to that of other leading industrial nations is in the long run necessary, therefore, both from the standpoint of the U.S. balance-of-payments position and to continue to improve our standard of living. The investment credit as a form of investment stimulation already is in use by the United Kingom, Belgium, and the Netherlands, and is in the process of being enacted by the Australian Parliment.

To achieve an increased rate of capital formation, a two-pronged course of action is being followed in the area of capital formation. First, the Treasury Department has recently announced a series of depreciation revisions. The objective of these revisions is to provide realistic tax lives in light of past actual practices and present and foreseeable technological innovations and other factors affecting obsolescence. The new guideline lives are expected initially to result in an annual revenue reduction of $1.5 billion and to reduce depreciable lives in the case of corporations surveyed by 21 percent. Another facet of this objective is to achieve a more simple and flexible system of depreciation through the use of guideline lives for broad classes of assets used by each of the industries in our economy.

Realistic depreciation alone, however, is not enough to provide the essential economic growth. In addition, a specific incentive must be provided if a higher rate of growth is to be achieved. The investment credit will stimulate investment, first by reducing the net cost of acquiring depreciable assets, which in turn increases the rate of return after taxes arising from their acquisition. Second, investment decisions are also influenced by the availability of funds. The credit by increasing the flow of cash available for investment, will stimulate investment. The increased cash flow will be particularly important for new and smaller firms which do not have ready access to the capital markets. Third, the credit can be expected to stimulate investments through a reduction in the "payoff" period for investment in a particular asset. This reduction in risk, coupled with the higher rate of profitability and increased cash flow, will lower the level at which decisions to invest are made and will help to restore to past levels the proportion of the annual national output devoted, through investment in machinery and equipment, to capital formation.

The objective of the investment credit is to encourage modernization and expansion of the Nation's productive facilities and thereby improve the economic potential of the country, with a resultant increase in job opportunities and betterment of our competitive position in the world economy. The objective of the credit is to reduce the net cost of acquiring new equipment; this will have the effect of increasing the earnings of new facilities over their productive lives and increasing the profitability of productive investment. It is your com-

mittee's intent that the financial assistance represented by the credit should itself be used for new investment, thereby further advancing the economy. Only in this way will the investment credit fully serve the overall national interest in greater productivity, a healthy and sustained economic growth, and a better balance in international payments.

Some have suggested that tax changes designed to add to consumer demand are the appropriate way to raise the level of investment. However, to rely only on such an approach suggests primarily expansion of existing kinds of equipment and techniques, rather than more efficient and larger quantities of capital per worker and therefore greater productivity. The credit adds to the quantity and quality of capital available per worker, and increases the relative attractiveness of investment at home compared with investment abroad.

Finally, the statement sometimes made that the credit is a subsidy overlooks the fact that other alternatives, such as faster depreciation, for example, share the same characteristics of giving the investor in equipment a monetary reward beyond what he would receive on the basis of realistic accounting. The credit, however, is preferable to higher depreciation charges because the latter tend to distort income accounting and produce higher costs for book purposes, which frequently could be expected to be reflected in higher product prices.

B. Comparison of committee amendments with House provision

Your committee has retained the basic House provision on the investment credit. As in the House bill, the credit generally allowable is 7 percent of the investment (3 percent in the case of certain public utilities) and this amount may be offset in full against tax liability up to $25,000, and against one-quarter of the tax liability above this level. Again, as in the House bill, property with an estimated useful life of 8 years or more is fully taken into account in computing the credit, property with an estimated life from 6 to 8 years is taken into account at two-thirds of its basis, while property with an estimated life from 4 years up to 6 years is taken into account at one-third of its basis. In addition, as provided by the House bill, machinery and equipment are the principal types of investments eligible for the credit.

Despite the substantial similarity of your committee's and the House versions of the investment credit, there are important differences. The most important of these is the reduction of the amount on which depreciation may be taken, in the case of assets eligible for the investment credit, by the amount of the investment credit allowable. Your committee believes that where a taxpayer purchases a $100 asset, for example, if $7 of this purchase price is to be allowed as a direct reduction in his tax in the form of a credit, this same amount should not be allowed to him again as a depreciation deduction in computing income subject to tax. In such a case the taxpayer's real contribution toward the purchase of the $100 property is limited to $93 and therefore it seemed appropriate to your committee to limit the depreciation recovery to this same $93.

A second change made by your committee provides that where property is lost or destroyed as a result of a casualty or is stolen and is insured, reinvestment of the insurance proceeds in replacement property is not to be eligible for an investment credit. This eliminates the

allowance of a credit in such cases, where the taxpayer has not made a contribution of additional funds toward the acquisition of new property.

A third change made by your committee provides that the investment credit is to be available only with respect to property acquired or constructed after June 30, 1962, rather than on or after January 1, 1962. Your committee concluded that taxpayers had no basis for assuming that an investment credit would be provided by Congress during the first half of 1962 when, for most of this period, the provision had not yet been even considered by the Senate or your committee. The allowance of the investment credit for this period, therefore, would represent a windfall for the taxpayers involved.

A fourth change made provides that livestock (including race horses) are not to be eligible for the investment credit since they are not included in the category of property resulting in ordinary income (to the extent of depreciation deductions) at the time of sale.

A fifth change made in the investment credit by your committee was to provide a 3-year carryback of unused investment credits. As pointed out above, the investment credit, in the case of a taxpayer with a tax liability of more than $25,000, could offset only one-quarter of the tax liability in excess of $25,000. Under the House bill any "unused" investment credit remaining could only be carried forward and used in any of the 5 succeeding years, again subject to the applicable limitations for those years. Testimony before your committee pointed out that the absence of a carryback of an unused credit in such cases would tend to encourage investment in prosperous periods and discourage it in depressed periods, when tax liability was relatively low. To offset this effect, your committee's bill provides for a 3-year carryback of any unused investment credit (but not to a period before June 30, 1962).

In a sixth and final change, your committee has deleted the requirement that one electing to treat a lessee of property as a purchaser must be engaged in the business of leasing property. Under your committee's change, any lessor of property meeting the other requirements may make the election.

C. General explanation of provision

1. The general pattern of the credit.—The bill provides a credit (in code sec. 38), which may be offset directly against income tax liability. The credit generally is an amount equal to 7 percent of "qualified investment" which includes both purchases of new equipment, and also, to a limited extent, purchases of used equipment. In the case of property with an expected useful life of 4 up to 8 years, the investment taken into account in computing the 7 percent credit is graduated from one-third in the case of the 4-year assets up to 100 percent in the case of property with a useful life of 8 years or more. In the case of most public utilities, however, only what amounts to a 3-percent investment credit is allowed. Under your committee's amendments the depreciation base of the assets involved is reduced (except for purposes of computing the credit) by the amount of the investment credit involved.

The types of property, whether new or used, which are included in qualified investment are described as "section 38 property." This property includes most tangible personal property. It also includes

certain real property, other than buildings (or structural components) if the property is used directly in manufacturing, production, transportation, etc.

Once the amount of the 7-percent credit against tax is determined, the amount which may be claimed in any one year is limited to the tax liability, or if this tax liability exceeds $25,000, the credit (to the extent it exceeds this amount) is limited to 25 percent of the tax liability. However, a 3-year carryback and a 5-year carryforward are provided for any of these credits which because of this limitation are unused. The bill also provides that where the property is disposed of (within 8 years) before the end of its life as estimated for the credit the credit is reduced to the amount which would have been allowed initially had the useful life of the asset been correctly estimated.

These provisions are described briefly below.

2. Qualified investment.—Investment which is eligible for the 7-percent investment credit is referred to in the bill as "qualified investment" (sec. 46(c)). Qualified investment includes both new property and a limited amount of used property. Property qualifies for the investment credit in the year it is placed in service by the taxpayer, even though under the depreciation convention used by the taxpayer, he may not be eligible to start depreciation on the property until the coming year.

The percentage of investment which the taxpayer may take into account as qualified investment varies to some degree with the expected useful life of the property in his business. No part of the investment in property with an expected useful life of less than 4 years is taken into account. Property with an expected useful life of 4 years and up to (but not including) 6 years is taken into account at one-third of the amount of the investment actually made; property with an expected useful life of 6 years and up to (but not including) 8 years is taken into account on the basis of two-thirds of the investment made; and property with a longer life is taken into account at the full amount of the investment.

Public utility property is taken into account as qualified investment at three-sevenths of the amount otherwise allowable. Thus, in the case of 4- or 5-year public utility property, one-seventh of the investment is taken into account; in the case of 6- or 7-year property, two-sevenths of the investment is taken into account; in the case of property with a life of 8 years or more, three-sevenths is taken into account. This means that in the case of public utility property with an expected useful life of 8 years or more, in effect a 3-percent credit is allowed. Public utility property for this purpose means property used predominantly in an electrical energy, water or sewage disposal business, a local gas distribution business, a telephone business, or a domestic telegraph business, but only if the rates involved in all of these cases are subject to regulation by a governmental agency or commission.

Your committee's amendments provide that "qualified investment" is to be reduced in the case of property which is a replacement for other property destroyed or damaged by fire, storm, shipwreck, or other casualty or stolen, where this latter property was insured (or compensation was otherwise received). In such cases the amount treated as qualified investment in the case of the property acquired as

a replacement is reduced by the amount of the insurance (or other compensation) or by the amount of the basis of the replaced property if lesser. This prevents a taxpayer from obtaining an investment credit windfall from insurance proceeds where the taxpayer neither puts up new funds nor expands his business. (This provision applies only when it results in a larger cutback in qualified investment allowable than the recapture rule described subsequently.)

3. *New and used property.*—The new property taken into account as qualified investment (sec. 48(b)), under your committee's amendments must be purchased or otherwise acquired after June 30, 1962, and its first use commenced by the taxpayer after that date. Other new property eligible for the credit also includes property constructed, reconstructed, or erected by the taxpayer after that date. These are the same rules which applied with respect to the new forms of depreciation provided in 1954.

Used property (sec. 48(c)), eligible for the credit, also must be purchased after June 30, 1962, but, of course, is not property which is new in use with the taxpayer. To prevent abuse, however, there has been omitted from the term "used property," available for the credit that which (after acquisition by the taxpayer) is used by a person who used the property before such acquisition (and also that which is so used by a person who is related to a person who used the property before its present acquisition).

The cost of any used property which may be taken into account is limited to $50,000 a year. Where used property with varying useful lives is acquired the taxpayer may select the property to be taken into account for the investment credit. Presumably he will select assets with lives of 8 years or more since there is no one-third or two-thirds reduction in such cases.

In the case of a husband and wife filing separate returns, the amount of used property which may be taken into account by each is $25,000 instead of $50,000, unless one of the two has not purchased any used section 38 property, in which case the other spouse may claim the entire amount up to $50,000. This prevents any double allowance for married couples. In the case of affiliated groups of corporations (with a 50-percent test of common ownership instead of the 80 percent usually applied), there is to be one $50,000 used property allowance for the group and it is to be apportioned among the members of the group in accordance with their purchases of this property. In the case of partnerships, this limitation applies both at the partnership level and also with respect to each partner. Thus, $50,000 is the limit with respect to used property which may be qualified for any partnership, and then there is a further $50,000 limit at the partner level. This latter limit may further restrict the used property eligible for the credit where a partner, in addition to his share of investment in one partnership, has, either from another partnership or as a sole proprietor, additional used property investment for which he may receive a credit. The total of these which qualify for the credit may not exceed $50,000.

To prevent a double allowance where used property is traded in on used property, or where used property is disposed of (otherwise than by casualty or theft) and other used property "similar or related in service or use" is acquired as a replacement, the cost otherwise allowable for the used property acquired is reduced by the adjusted basis

of the property disposed of in both of these types of cases. However, this "replacement" reduction in the credit is not to apply where there otherwise is a reduction in the credit for the property disposed of because of its disposal within 8 years and before the end of what had been its estimated useful life. (See heading 6 below.)

4. "Section 38" property.—Section 38 property (defined in sec. 48(a)), is the only property (either new or used) which is treated as "qualified investment." Except for the exclusions noted below, all tangible personal property qualifies as section 38 property. Except for buildings and their structural components, real property which is used as an integral part of manufacturing, production or extraction or of furnishing transportation, communications, electrical energy, gas, water or sewage disposal services also qualifies as section 38 property. This is also true of real property (other than buildings and structural components) used for research or storage facilities with respect to any of the above categories. Tangible personal property is not intended to be defined narrowly here, nor to necessarily follow the rules of State law. It is intended that assets accessory to a business such as grocery store counters, printing presses, individual air-conditioning units, etc., even though fixtures under local law, are to qualify for the credit. Similarly, assets of a mechanical nature, even though located outside a building, such as gasoline pumps, are to qualify for the credit. Real property (other than buildings and structural components) which qualifies as integral parts of categories referred to above includes such assets as blast furnaces, oil and gas pipelines, railroad track and signals, and fences used in connection with raising cattle.

Section 38 property must be depreciable property and have a useful life of 4 years or more. As indicated elsewhere property with estimated useful lives of from 4 to 8 years is only partially taken into account for purposes of the investment credit.

There also are certain categories of property which are excluded from the definition of section 38 property and, therefore, cannot qualify for the credit. These exclusions are:

(1) Property used predominantly to furnish lodging or in connection with the furnishing of lodging. However, there are two exceptions to this exclusion. First, property used in nonlodging commercial facilities (such as a restaurant) located in lodging facilities (such as a hotel) may qualify for the credit if the nonlodging commercial facilities are available for use by the general public on the same basis as for the lodgers. Second, property used in a hotel or motel which primarily serves transient guests may qualify for the credit. The first of these two rules is essential to place nonlodging commercial facilities located in an apartment building, etc., on an equal competitive basis with similar facilities located elsewhere. Property necessary for the operation of a hotel or motel also is used in a regular commercial venture and, therefore, it was believed that it too should be eligible for the investment credit.

(2) Property used by a tax-exempt organization (other than in a business to which the unrelated business income tax applies). The limitation on the allowance of the credit in this case is designed to prevent an investment for use in connection with an exempt function from decreasing any tax on an unrelated trade or business.

(3) Property used by (or leased to or by) governmental units. Property leased to governmental units is omitted since allowing the lessor in such cases an investment credit would not be expected to increase the use of such property by the governmental units.

(4) Property used predominantly outside of the United States. However, there are certain exceptions where this type of property is eligible for the credit, namely, in the case of domestically owned aircraft, rolling stock of railroads, vessels and motor vehicles, where the use is partially within and partially without the United States. Similarly, an exception is made for domestically owned containers which are used in the transportation of property to or from the United States. A further exception is made for domestically owned property used in exploring for, developing, removing, or transporting natural resources from the outer Continental Shelf of the United States. Property used predominantly outside of the United States (with the exceptions noted) is omitted, since the primary purpose of the credit is to encourage investment within the United States.

(5) Livestock (including racehorses).

5. *Limitation on tax credit.*—The tax credit, under the bill, as amended by your committee (sec. 46(a)(2)) may not exceed the tax liability, or if the tax liability is in excess of $25,000, may not exceed $25,000 plus 25 percent of the tax liability over this amount. This limitation, while leaving substantial leeway for utilizing the credit, is designed to prevent it (in combination with other tax benefits) from relieving the taxpayer from any substantial tax contribution. However, in recognition of the problems of small business, the bill does not impose this limitation with respect to the first $25,000 of any tax liability.

Although this limitation with respect to the allowance of the investment credit is imposed for the year in which the investment is made, nevertheless, any investment credit which, because of this limitation, cannot be used in the current year may be carried to other years by the taxpayer. Under your committee's amendments the taxpayer may first carry an unused credit back to the 3 prior years (but not before June 30, 1962) and then forward to any of the succeeding 5 years using the credit in any of these years to the extent it is less than the applicable tax limitation.

Tax liability for purposes of this limitation is computed without regard to the accumulated earnings tax or personal holding company tax liability, but after the application of the foreign tax credit, the 4-percent dividends-received credit, the credit for partially tax-exempt interest and the retirement income credit. In order to prevent a full allowance with respect to $50,000 of tax liability (instead of $25,000) in the case of a married couple, the bill provides that for a married individual filing a separate return the tax liability limitation is $12,500 instead of $25,000. However, if either the husband or the wife has no qualified investment (or unused credit carryback or carryover), the one having the investment or carryover may make use of the entire $25,000. In the case of an affiliated group there is one $25,000 of tax liability which can be fully offset by an investment credit and this is by regulations to be apportioned among the members of the affiliated group.

6. Recapture rule.—To guard against a quick turnover of assets by those seeking multiple credit—the bill provides (in sec. 47) a special adjustment or recapture. Under this provision if property is disposed of, or otherwise ceases to be section 38 property, the tax for the current year is to be increased by the reductions in investment credits (which would have resulted in the prior years) had the investment credits allowable been determined on the basis of the *actual* useful life of the property rather than its *estimated* useful life. This means, for example, that if an asset which had previously been estimated to have a useful life in the business of 8 years or more actually is used by the taxpayer only for 6 years, the investment credit for the year in which the investment was originally made will be recomputed on the basis of two-thirds the investment made. Had this asset been sold after 4 or 5 years' use, the allowable investment would have been recomputed on the basis of one-third of the actual investment and had it been sold after a still shorter period, the credit would have been eliminated.

Although the credit is recomputed for the earlier year in which the investment was made, the actual adjustment in tax occurs in the current year, namely, the year in which the asset is disposed of (or otherwise ceases to be sec. 38 property). This makes it unnecessary actually to recompute taxes in the prior years, or to extend the statutory periods of limitations. An adjustment is also made in any carrybacks and carryovers of unused credits so that they too will reflect the reduced amount of investment to be taken into account.

Although disposal of assets (where this is less than 8 years) within a shorter period of time than their estimated useful life usually will be the factor resulting in downward adjustments in the credit allowed, the credit must also be adjusted if property ceases to qualify as section 38 property; where, for example, it is converted to use predominantly outside of the United States. A downward adjustment in the credit also is required where property is converted to public utility property for which only a reduced credit is available. As indicated previously, a credit is allowed for certain types of public utility property equal only to three-sevenths of the credit generally allowable. Where property is converted to such use (again, before the end of its estimated useful life and within the 8-year period) a downward adjustment must be made. In this case, however, instead of disqualifying one-third, two-thirds, or all of the property, depending upon the period of time involved before the conversion to public utility use is made, four-sevenths of such an adjustment is made, since the public utility property itself qualifies for the credit for the remaining period of time but on a reduced basis.

Few exceptions are made to the adjustment rule described above because in no case does this result in a lesser credit than would be available had the useful life of the property been estimated accurately. Moreover, since the tax increase occurs in the current year, and not with respect to the prior year in which the investment occurred, no interest is charged with respect to the increase in tax resulting from the reduction in credit. As a result, your committee believed that it was necessary to forego the application of the adjustment rule only in the case of the transfer of property by reason of the death of the taxpayer or in the case of corporations where a successor corporation "stands in the shoes" of the predecessor corporation. The successor

corporation in such a case, of course, must continue to hold the property for the appropriate period of time, or an increase will be made in its tax because of the disposition of the property prior to the end of its estimated useful life. In addition, the recapture rule is not to apply where the replacement rule, applicable where insurance proceeds are received for casualty losses or thefts, results in a revenue reduction in qualified investment. (See No. 2 above.)

7. *Downward adjustment in basis of property.*—The bill as amended by your committee provides (sec. 48 (g)) that the cost or other basis of "section 38 property" is to be reduced by 7 percent of the qualified investment except for purposes of computing the credit itself. As previously indicated, this downward adjustment is provided because your committee believes that there is no reason to allow the taxpayer depreciation with respect to the portion of the investment in effect paid for by the Government.

The bill provides that the basis of all qualified investments is to be reduced by 7 percent. Since "qualified investment" is after adjustment for different estimated lives (and also after the special adjustment where the property involved is public utility property) the uniform 7-percent downward adjustment provides the appropriate result in most cases. However, there are cases where this adjustment may be too large. This is true, for example, where because of the limitation to 25 percent of tax liability, not all of the credit is used in the taxable year, 3 years to which the credit may be carried back and 5 years to which it may be carried forward. To compensate for this overadjustment the bill provides taxpayers with a special deduction in computing taxable income in the first year after all carryforwords for a credit have expired, equal in amount to any unused portion of the credit. If the taxpayer dies or ceases to exist prior to that time this special deduction (or appropriate portion of it) is allowed the taxpayer in his last year.

A second circumstance under which the downward adjustment referred to here may be too great is that where a property is disposed of before its full estimated life has expired and in less than 8 years. In such cases the investment credit is cut back under the recapture rule explained in the prior section with the result that the original adjustment to the basis of the property was too large. To the extent of this cutback in the investment credit, the bill provides for an increase in the basis of the property at the time just preceding its disposition.

8. *Election for leased property.*—The bill provides (in sec. 48(d)) that a lessor may elect with respect to new property to treat the investment as if made by the lessee instead of the lessor. This election applies only with respect to new property and is not available for used property. Permitting the investment credit to be passed on to the lessee in these cases is believed to be desirable since, as a result of this provision, it is possible for the lessor to pass the benefit of the investment credit on to the party actually generating the demand for the investment.

If the lessor makes this election, then the lessee is treated for purposes of this provision as if he had acquired the property himself, that is, generally he will be treated as if he had acquired the property for the lessor's cost or other basis for the property. However, if the lessor constructed the property (or a corporation controlled by or

which controlled the lessor did so) the lessee is treated as having acquired the property for its fair market value. The useful life of the property in the hands of the lessee in such cases is to be its useful life in the hands of the lessor for purposes of computing the size of the credit available. This is true whether or not the lease itself is for a shorter period of time. Of course, in such cases if the lessee does not renew the lease and hold the property for the estimated useful life of the property in the hands of the lessor, then a downward adjustment will be made in his investment credit.

Where the lessee is allowed the investment credit there is no adjustment of the lessor's basis for depreciation (as discussed in No. 7 above) but a reduction of the lessee's deduction for rent is provided.

9. Special classes of taxpayers.—A number of special categories of taxpayers receive special tax treatment under the Internal Revenue Code which makes it inappropriate in their cases to allow the full investment credit. For other taxpayers, the code provides that income may be taxed in part to the organization and in part to its shareholders or beneficiaries. In these situations your committee's bill either cuts down the allowance of the tax credit in proportion to the special benefit received, or provides for the apportioning of the investment credit between the organization and its shareholders or beneficiaries in accordance with their sharing of income for tax purposes. Similar adjustments are also provided in the $25,000 tax liability limitation.

In the case of mutual savings banks, building and loan associations and cooperative banks, the investment credit allowable is reduced by 50 percent (largely offsetting the 60 or 50 percent special deductions they are allowed). The $25,000 tax liability limitation is also similarly reduced for these organizations.

In the case of regulated investment companies and real estate investment trusts, the qualified investment allowed them and the applicable $25,000 tax liability limitation are reduced in the same proportion in which their taxable income is reduced by dividends paid to shareholders or beneficiaries. Similarly, in the case of cooperatives, the qualified investment and $25,000 tax liability limitation to be taken into account are reduced in the same proportion in which their taxable income is reduced for patronage dividends (and in the case of exempt cooperatives its deductions for dividend payments on capital stock, patronage distributions with respect to U.S. business and income distributed to patrons from sources other than patronage).

In the case of subchapter S corporations, i.e., corporations treated in a manner similar to that of partnerships, since it is the shareholders, rather than the corporation, who are taxed on the income of the corporation, the bill (sec. 48(e)) divides the qualified investment for each year on a pro rata basis among the shareholders of the corporation at the end of the year. In this case since the shareholders are treated as the taxpayer, the investment maintains its character as new or used section 38 property in their hands. Similarly, the bill (in sec. 48(f)) provides that qualified investment in the case of estates or trusts is to be apportioned between the estate or trust on one hand and the beneficiaries on the other on the basis of the income of the estate or trust allocable to each. As in the case of the subchapter S corporations, the beneficiary is treated as the taxpayer with respect to the

investment apportioned to him and therefore the investment retains its character in his hands as new or used section 38 property. The $25,000 tax liability limitation in the case of the estate or trust is reduced in proportion to the total income allocated to other than the estate or trust.

10. Carryovers in the case of certain corporate acquisitions.—Generally, in the case of certain tax-free acquisitions of assets of one corporation by another, present law provides that certain items of the first corporation are to be carried over and attributed to the second. This includes such items as net operating loss carryovers, earnings and profits, methods of accounting, methods of computing depreciation allowance, etc. The bill adds to this list (sec. 381(c)(23)) a carryover to the acquiring corporation in the case of these tax-free reorganizations of the status of the prior corporation with respect to items required to be taken into account for purposes of the investment credit. This mainly is concerned with (1) the carryover of the possibility of adjustment with respect to the investment credit where an asset is held for less than the full period of its estimated useful life and (2) the carryover of any unused investment credit in the prior 5 years.

11. Effective date.—The bill provides that the investment credit is to apply to taxable years ending after June 30, 1962. However, in the definition of new section 38 property and also used section 38 property (the only types of property eligible for the credit) it is provided that a credit is to be available only with respect to acquisitions after June 30, 1962, or in the case of property newly constructed, reconstructed or erected by the taxpayer, only with respect to the portion of the property which is constructed, reconstructed or erected after that date. The combination of the effective date and these definitions of new and used section 38 property in effect provide that the investment credit is to be available only with respect to property acquired (also property constructed, reconstructed, or erected by the taxpayer) after June 30, 1962, with respect to taxable years ending after that date.

III. APPEARANCES, ETC., WITH RESPECT TO LEGISLATION

(Sec. 3 of the bill and sec. 162(e) of the code)

A. Reasons for provision

Present law allows deductions for income tax purposes for ordinary and necessary expenses paid or incurred in carrying on a trade or business. No mention, however, is made in the statute of expenses incurred in making appearances, submitting material, or communicating with respect to legislative matters. However, Treasury regulations in effect prior to the enactment of the 1954 Code disallowed deductions for expenditures for such purposes (regulations 118, secs. 39.23(o)–1(f) and 39.23(q)–1(a)).

In 1959, the Supreme Court handed down two companion decisions upholding the validity of these regulations, *Cammarano* v. *U.S.* and *F. Straus & Sons, Inc.* v. *U.S.* (358 U.S. 498 (1959)). The Court held that although the amounts expended for legislative matters were "ordinary and necessary"—in fact essential to the very survival of the taxpayer's business—nevertheless they were not deductible because the regulations barred the deduction of this particular type of expense.

The Court recognized that the statute contained no provisions specifically supporting the regulations, but stated that they had acquired the force of law by reason of congressional reenactment of the underlying statute.

Following the *Cammarano* decision, the Treasury Department promulgated new regulations relating to deductions incurred with respect to legislative matters. These regulations, while following the general rules set forth in the earlier regulations, for the first time stated specifically that several different classes of expenditures are to be disallowed as deductions. For example, the new regulations require the disallowance of a deduction for the portion of dues and other payments to any organization, a "substantial part" of the activities of which consist of lobbying to the extent that such amounts are "attributable to" these activities. Similarly, the regulations now state that expenditures for the promotion or defeat of legislation include expenditures for the purpose of attempting to influence members of a legislative body, directly or indirectly, by urging or encouraging the public to contact the members.

The regulations issued by the Treasury Department in 1959 brought to a head many administrative and enforcement problems and uncertainties which have plagued both the Government and taxpayers. The difficulty in allowing trade or business expenses generally, but isolating expenses relating to legislative matters and denying deductions for them, stems in part from the difficulty in segregating and classifying such expenses. This is a form of detailed recordkeeping to which taxpayers are not accustomed. Moreover, in the case of many expenses which may primarily be incurred to inform the business itself as to the application of certain proposed legislation, when such information is also made available to legislators it is difficult to determine how an allocation of the expense should be made between legislation and mere planning of the company. Moreover, in the case of an organization, a determination must also be made as to whether the expenses of this type are substantial—a term which involves a difficult line of demarkation.

More important than the administrative and enforcement problems, however, are the policy considerations involved in denying expenses with respect to legislative matters. It appears anomalous, for example, that expenses incurred in appearing before legislative bodies or before legislators are not deductible while appearances before executive or administrative officials with respect to administrative matters, or before the courts with respect to judicial matters, are deductible where the expenses otherwise qualify as trade or business expenses. Your committee believes that the present bar on deductions with respect to legislative matters must be modified to place presentations to the legislative branch of Government on substantially the same footing in this respect as that which obtains in the other two coordinate branches of Government.

It also is desirable that taxpayers who have information bearing on the impact of present laws, or proposed legislation, on their trades or businesses not be discouraged in making this information available to the Members of Congress or legislators at other levels of Government. The presentation of such information to the legislators is necessary to a proper evaluation on their part of the impact of present or proposed legislation. The deduction of such expenditures on the

part of business also is necessary to arrive at a true reflection of their real income for tax purposes. In many cases making sure that legislators are aware of the effect of proposed legislation may be essential to the very existence of a business. The deduction of legislative expenses for those who incur them for personal reasons is not proposed here, since personal expenses generally are not deductible with respect to administrative or judicial presentations and have no bearing on the determination of true taxable income of a business.

B. Comparison of committee amendment with House provision

Your committee has retained the House provision relating to appearances, etc., with respect to legislation. The only change made is the addition of one category of deductible expenses. Your committee's amendment provides, in addition to the categories specified in the House bill, for the deduction of expenses incurred by a taxpayer in carrying on a trade or business if the expenses are in direct connection with the communication of information between the taxpayer and employees or stockholders with respect to legislation, or proposed legislation, of direct interest to the taxpayer. As in the case of the categories referred to in the House bill, expenses of this type, in order to be deductible, may not be for participation or intervention in political campaigns on behalf of candidates for public office or in connection with attempts to influence the general public (or segments thereof) with respect to legislative matters, etc.

C. General explanation of provision

The bill adds a new subsection (sec. 162(e)) to the provision of present law relating to the deduction of trade or business expenses. It provides that certain types of expenses incurred with respect to legislative matters are to be deductible if in all other respects they qualify as trade or business expenses.

The expenses which may be deducted are divided into three categories. The first category relates to expenses in direct connection with appearances, submission of statements or sending of communications. These appearances, statements or communications may be presented either to committees or individual Members of Congress or to committees or individual members of State or local governmental legislatures. The second category of expenses which may be deducted are those in direct connection with the communication of information between the taxpayer and an organization of which he is a member. The third category of expenses which may be deducted are those in direct connection with the communication of information between the taxpayer and an employee or stockholder. This communication of information may be either from the organization, employee or stockholder to the taxpayer or vice versa. In the case of all three categories of expenses referred to above, in order for the expense item to be deductible, it must be concerned with legislation or proposed legislation of direct interest to the taxpayer (and to the organization in the second case). Thus, the expenses may not be in connection with legislative matters such as nominations, etc., but rather must be in connection with specific legislation or proposals for legislation.

The bill also provides that where a taxpayer is a member of an organization and the organization pays or incurs the expenses of the types referred to above on behalf of its members, the dues which the

taxpayer pays to the organization in carrying on his trade or business are to be deductible to the extent they are used for such purposes. The remainder of the dues is likely already to be deductible as an ordinary and necessary business expense. Of course, the dues to an organization may be deductible although not all of the organization's legislative activity is connected with each specific member's trade or business. It is sufficient if all of the organization's legislative activity is related to the trade or business of a significant number of the members.

The bill provides two limitations on the deductions of the above-specified expenses for the specified types of legislative activity. It is not intended by your committee that any deduction be allowed for an amount paid or incurred for participation or intervention in any political campaign for any candidate. Of course, this includes participation or intervention in political campaigns in opposition to a candidate as well.

Your committee's bill further provides that no expense deduction is to be allowed for expenditures to influence the general public, or segments thereof, with respect to legislative matters, elections, or referendums. Thus, except to the extent allowed by existing law, no deduction is intended to be allowed for expenses incurred in connection with what is usually called "grassroot" campaigns intended to develop a point of view among the public generally which in turn is directed toward the legislators. However, your committee does not intend that this limitation should have any effect upon the deductibility of dues, contributions or other payments to organizations whose activities consist primarily of gathering and disseminating factual information, data and statistics. For example, a nonprofit organization would not be affected by the limitation if it were organized and operated for the propose of studying governmental affairs, Federal, State, or local (which might include analysis of legislation or proposed legislation) and of publishing and distributing to its members and the public factual reports and information on such governmental affairs. Such factual reports might contain data which could be used by subscribers and others to promote or defeat legislation, but so long as the organization itself did not engage in lobbying activities to promote or defeat legislation, payments to such organization will continue to be deductible to the same extent as under existing law.

Nothing in this provision is intended to permit the deduction of entertainment expenses. Such amounts, if deductible at all, must meet the tests set forth in section 4 of the bill, explained below, without regard to this provision.

This provision is to be effective with respect to taxable years beginning after December 31, 1962.

IV. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES

(Sec. 4 of the bill and sec. 274 of the code)

A. Reasons for provision

The Treasury brought to the attention of Congress that widespread abuses have developed through the use of the expense account. In his tax message to the Congress last year, the President stated his

conviction that entertainment and related expenses, even though having a connection with the needs of business, confer substantial tax-free personal benefits on the recipients, and that in many instances deductions are obtained by disguising personal expenses as business expenses. He recommended that the cost of such business entertainment and the maintenance of entertainment facilities be disallowed in full as a tax deduction and that restrictions be imposed on the deductibility of business gifts and travel expenses.

Much of the abuse described by the President can be traced to the broad judicial and administrative interpretation given to the term "ordinary and necessary" which has resulted in many entertainment expenses being allowed as deductions where their connection with a trade or business is quite remote. Under present law, where a business purpose, however slight, exists, then the entertainment expenses generally are fully deductible if they are "ordinary and necessary" business expenses.

After careful consideration of the proposal, your committee has concluded that deductions for entertainment and traveling expenses and business gifts should be restricted to prevent abuses. The committee agrees that this abuse of the tax law should not be condoned, but on the other hand it does not believe that complete disallowance as recommended by the President is the proper solution to the problem. Rather, your committee is convinced that expenses incurred for valid business purposes should not be discouraged since such expenses serve to increase business income, which in turn produces additional tax revenues for the Treasury. If valid business expenses were to be disallowed as a deduction (particularly expenses associated with selling functions), there might be a substantial loss of revenue where business transactions are discouraged, or where they fail to be consummated. Moreover, the entertainment industry employs large numbers of service personnel, most of whom are unskilled workers who would find it difficult to obtain new employment in other fields if the disallowance of entertainment expenses created considerable unemployment in the entertainment industry. In such cases, taxes now paid by these workers would be lost to the Treasury.

B. Comparison of committee amendment with House provision

The House bill provides rules which in general would: (1) disallow a deduction with respect to entertainment activities, except to the extent that the expense is directly related to the active conduct of a trade or business; (2) disallow a deduction with respect to entertainment facilities, unless the facility is used primarily for the furtherance of the taxpayer's trade or business and the expense is directly related to the active conduct of the trade or business; (3) abolish the Cohan rule by requiring the taxpayer to substantiate, by adequate records or by sufficient evidence corroborating his own statement, all expenditures for entertainment and related facilities, and for travel and gifts; and (4) limit the deduction for gifts to $25 per year per recipient.

Your committee's bill to a considerable degree retains the basic structure of the House bill. However, the effect of the principal provision (the disallowing of a deduction for certain entertainment expenses) has been modified to permit the deduction of expenses for goodwill where a close association is established between the expense and the active conduct of a trade or business.

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The report of the Committee on Ways and Means made it clear that the House bill was not designed to disallow completely deductions for entertainment, amusement or recreation expenses, but rather it was intended to eliminate abuses. Under the general rule, no deduction would be allowed for any such expenses except to the extent that such expenses are directly related to the active conduct of a trade or business. Despite the clear language of the House bill and the stated intent of the provision, considerable uncertainty and confusion as to the actual effect of the House draft has been created by the interpretation given this language in the House committee report. It in effect interprets the proposed statutory language to disallow a deduction for any expense for entertainment, amusement, or recreation unless the expense is described in one of a series of specific exceptions to the general rule. Where the expense is covered by an exception, the rules of existing law would continue to govern the deductibility of the expense.

To eliminate the harshness resulting from the House report, amendment of the language of the House bill is necessary. Despite amendment of the House bill your committee has made certain that entertainment expense abuses are eliminated. By your committee's amendment an alternative rule is added to the House bill under which expenses for entertainment, amusement, or recreation (with respect to both activities and facilities) also will be deductible to the extent that such expenses are associated with the active conduct of a trade or business. This new language will permit deduction of expenses for entertainment, amusement, or recreation incurred for the creation or maintenance of business goodwill without regard to whether a particular exception applies. However, this new language will apply only if the taxpayer demonstrates a clear business purpose and shows a reasonable expectation of deriving some income or other benefit to his business as a result of the expenditure. If he meets this test, the expenditure will be considered to be associated with the active conduct of his trade or business; otherwise, the expense will be disallowed under your committee's amendment.

With respect to disallowance of a deduction for gifts in excess of $25, your committee has adopted the rule of the House bill but has modified the definition of "gift" for purposes of applying the limitation. Under the modified definition: (*a*) certain specialty advertising gifts, (*b*) advertising material for use in connection with the recipient's business, and (*c*) certain awards to employees costing not more than $100, will not be taken into account in determining whether the $25 limitation has been exceeded.

The requirements of the House bill regarding substantiation of claimed deductions for entertainment, amusement, or recreation expenses, gifts, and traveling expenses, have been approved without change.

The provision of the House bill which provided that expenses for meals and lodging included in the term "traveling expenses" were to be deductible only if "reasonable" has been clarified to assure that "traveling expenses" are not to include expenses for meals and lodging which are lavish or extravagant. In addition, your committee has added to the House-passed bill a new rule for the allocation of traveling expenses where the trip involves both business and pleasure. Under this rule, which would eliminate abuses involving tax deduction for vacation trips, if the trip is for more than 1 week and the personal

portion of the travel time is in excess of 25 percent of the total time away from home, the traveling expenses (including meals and lodging) must be allocated between business and pleasure and only the portion allocated to business will be deductible.

As amended by your committee, the provisions of this section of the bill are to apply to taxable years ending after December 31, 1962, but only with respect to expenditures incurred after that date.

C. General explanation of provision

Your committee's bill adds a new provision to the code (sec. 274), which disallows, in whole, or in part, certain expenses which would be fully deductible under present law. The requirements imposed by this bill are in addition to the requirements for deductibility imposed by other provisions of existing law, which must be met by the taxpayer before this new provision becomes operative. Hence, if an expenditure is claimed as a business expense deduction under section 162, the taxpayer must first establish that it constitutes an ordinary and necessary expense incurred in carrying on a trade or business, before the new provisions of this bill become applicable.

Since the only purpose of this section is to disallow deductions, it will not make deductible any expense which is disallowed under the "ordinary and necessary" test of present law. Moreover, this section does not affect the question of the includibility or excludibility of an item in income of any individual. The rules presently applicable under present law will continue to govern in this respect.

1. Disallowance of expenses for entertainment activities.—The first part of the provision provides that no deduction is to be allowed for any expense with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, except to the extent that the taxpayer establishes that the expense was directly related to the active conduct of his trade or business, or that the expense was associated with the active conduct of his trade or business. Certain exceptions to this rule are provided, however, for expenses not required to meet the new tests. They are discussed in No. 6 below.

Entertaining guests at night clubs, country clubs, theaters, football games, and prizefights, and on hunting, fishing, vacation and similar trips are examples of activities that constitute "entertainment, amusement, and recreation." In addition, "entertainment" includes any business expense incurred in the furnishing of food and beverages, a hotel suite, a vacation cottage, or an automobile either to a customer (present or potential) or to any member of such a customer's family. If deduction is claimed for any expense for "entertainment, amusement, or recreation" the facts and circumstances of each particular case will determine the extent to which the expenses will be disallowed.

The trade or business of the taxpayer will determine whether an activity is of a type generally considered to constitute entertainment, amusement, or recreation. For example, with respect to a taxpayer who is a professional hunter, a hunting trip would not generally be considered a recreation-type activity. On the other hand, with respect to a taxpayer whose trade or business consists of selling machine tools or manufacturing clothing, a hunting trip generally would be considered a recreation-type activity. Similarly, attending a theatrical performance would generally be considered an entertain-

ment-type activity, but in the case of a professional theater critic, attending a theatrical performance would not constitute an entertainment activity.

An objective standard also will overrule arguments such as the one which prevailed in *Sanitary Farms Dairy, Inc.* (25 TC 463 (1955)) that a particular item was incurred, not for entertainment, but for advertising purposes. That case involved a big-game safari to Africa. The taxpayer argued successfully before the Tax Court that the expense of the hunt (including costs of making motion pictures which were later shown to customers and potential customers) were incurred solely for advertising purposes. Under the bill, if the activity typically is considered to be entertainment, amusement, or recreation, it will be so treated under this provision regardless of whether the activity can also be described in some other category of deductible items. This will be so even where the expense relates to the taxpayer alone.

Many entertainment expenses which have a business connection nevertheless will not be deductible. To justify their deduction, a taxpayer must establish that the incurring of the expenses relating to the entertainment activities was directly related to or associated with his effort to obtain new business or to encourage the continuation of an existing business relationship. This means that he must show a greater degree of proximate relation between the expenditure and his trade or business than is required under present law. To illustrate this principle, assume a taxpayer entertains a buyer and the buyer's family at lunch and the theater. Under existing law, he claims a deduction for the entire expense; under your committee's bill no deduction would be allowed for any portion of the expense attributable to the buyer's family since as to them he is unable to show a sufficiently close relationship between the expense and his trade or business.

It will not be sufficient that the entertainment expense is vaguely or remotely connected with a business motive; it must be demonstrated that the predominant purpose of the expense is to further the trade or business of the taxpayer. Where goodwill generated by the expense is vague or where the possibility of the expenditure resulting in the production of income is remote, no deduction will be permitted. For instance, under present law a taxpayer may deduct expenses of entertaining buyers and others associated with his trade or business even though at the time he does the entertaining he already has more business than he can handle. Under your committee's amendment, however, no deduction will be allowed because, with a large backlog of unfilled orders, such entertainment ordinarily cannot be regarded as being associated with efforts to produce income.

Under the bill, although deduction for entertainment expenses is restricted, such expenses will not be disallowed merely because they are incurred for the purpose of generating business goodwill. Goodwill has long been recognized as a legitimate objective of business entertaining and where the purpose of the expense and its clear relationship to a business is firmly established, the expense ordinarily will continue to be deductible. However, nothing in your committee's bill is to be construed as allowing a deduction for any expense which is against public policy or which violates the public conscience. Deducting an expense incurred for such purpose under the guise of generating "business goodwill" will not be condoned and under your

committee's amendment is not deductible. Thus, the cost of liquor purchased for the entertainment of customers and the promotion of goodwill (which under existing law has been held deductible) will be disallowed if the serving of liquor violates the public morals of the community as expressed in local law. Another example of expenses for immoral purposes which have been claimed on tax returns under existing law involves expenditures to provide "call girls" for the purpose of entertaining clients. Under your committee's amendment no deduction whatsoever is to be allowed for expenditures of this nature. In no legitimate sense are they "directly related to or associated with the active conduct" of a trade or business.

On the other hand, the following examples are indicative of circumstances under which entertainment expenses ordinarily will not be disallowed. Where the taxpayer conducts lengthy negotiations with a group of business associates and that evening the group goes to a night club, theater, or sporting event for relaxation, such entertainment expenses are regarded as directly related to the active conduct of business. Moreover, if a group of business associates with whom the taxpayer is conducting business meetings comes from out of town to the taxpayer's place of business to hold substantial business discussions, the entertainment of such business guests prior to the business discussions also is directly related to the conduct of the business. Similarly, if in between business meetings at a convention the taxpayer entertains his business associates attending such meetings, such expenses will be allowable.

Although your committee's bill permits entertainment expenses to continue to be deducted where a business purpose is shown, deduction will be limited to the portion of the expense which is directly related to or associated with business.

Objective standards will be employed to determine the apportionment between the part of the expense which meets either of these tests and the part which does not. Expenses not so related may not be deducted. Under this rule, if a taxpayer entertains a group of 10 individuals, 3 of whom are business prospects and 7 of whom are social guests, deduction will be allowed under the bill only for three-tenths of expenses incurred. Since the taxpayer's motive is not relevant to this determination, it would make no difference that the taxpayer in the above example would not have done the entertaining but for the attendance of the three business-related guests. This rule would disallow deductions for expenses in the following cases which, under existing law, are fully deductible:

A. Officer-shareholder and wife accompanied customer and wife to Las Vegas for 12-day vacation. Taxpayer paid the expenses for the four individuals. Officer-shareholder asserted that he would not have made the trip except for business purposes and that his wife's presence was required by the customer and his wife.

B. Officer-shareholder and his wife traveled to Alaska with customer and wife. Expense of wife was allowed based on representation that customer would not go without his wife and his wife would not go without such shareholder's wife.

C. Expenses for tractor demonstration attended by corporate taxpayer's principal officer-shareholder and his wife. A purported business reason for the wife's travel was established based on allowance of expenses for similar travel in the past.

In example A, no deduction would be allowed under your committee's bill because a vacation trip for a customer and his wife is not "directly related to the active conduct of the taxpayer's trade or business." In example B, deduction will be disallowed for expenses attributable to the taxpayer's wife and the customer's wife. In example C, no deduction would be allowed for expenses attributable to the taxpayer's wife.

D. Customers and their wives are entertained by taxpayer at Derby parties such as breakfasts and luncheons, etc.; by furnishing box seats and tickets for the Kentucky Derby; and entertainment at the Derby.

Under existing law, the entire amount expended was claimed as a deduction and was allowed. Under your committee's amendment, no deduction is permitted for expenses attributable to customers' wives because their connection with the taxpayer's trade or business is remote.

No deduction will be allowable under this provision for any "entertainment, amusement, or recreation" expenses which under the circumstances in which they are incurred are lavish or extravagant. This will be so even where a direct business purpose is firmly established. The application of this rule can be demonstrated by the following example:

E. The taxpayer, which is located in the midwest, asserted that lavish entertainment is essential in obtaining business and it established a Miami Beach residence for this purpose. The two principal officers and their wives are usually present at the residence when entertaining customers. Deductions allowed included depreciation on residence, food, liquor, boat expense and salaries of service employees and entertainment. Disallowance was made for amounts deemed to be personal expense.

Under the bill, no deduction would be allowed for any expenses attributable to the wives of either the principal officers or their customers (present or potential), or for any portion of the expenses incurred in example E which are lavish or extravagant. (The expenses of maintaining the residence are treated as expenses with respect to a facility, discussed in No. 2 below.)

Expenses for entertainment, amusement, and recreation should be identified by the taxpayer on his return and treated under the new rules of this bill. It will not be appropriate to include these expense items in other categories of business deductions, where their character will not be apparent, such as advertising, public relations, cost of goods sold, reimbursed expenses, etc. Failure to substantiate the claimed entertainment expenses by adequate records or other sufficient evidence may result in complete disallowance of the deduction.

2. Disallowance of expenses for entertainment facilities.—Your committee's bill (sec. 274(a)) also limits the deduction for expenditures incurred with respect to facilities used for entertaining. As in the case of expenses with respect to activities the new rules of this provision apply only if the expenses with respect to facilities qualify under existing law for deduction of business expenses. Moreover, these new rules establish additional tests which must be satisfied (in addition to the "ordinary and necessary" test of present law) in determining whether any deduction is to be allowed for expenses with respect to facilities. Under the bill, no deduction is to be allowed with respect to

expenses relating to facilities unless the taxpayer establishes (1) that the facility was used primarily for the furtherance of his trade or business and (2) that the expenditure was directly related to the active conduct of his trade or business, or that it was associated with the active conduct of his trade or business. In no event can the deduction exceed the portion of the expense which is directly related to (or associated with) the active conduct of the taxpayer's trade or business. Certain exceptions to this rule are provided, however, for expenses not required to meet the new tests. They are discussed in No. 6 below.

The term "facility" includes any item of personal or real property owned or rented by the taxpayer, such as a yacht, hunting lodge, fishing camp, swimming pool, tennis court, bowling alley, automobile, airplane, apartment, hotel suite, home in vacation resort, dining room, and cafeteria. In addition to items commonly regarded as expenses "with respect to a facility," such as expenditures for the maintenance, preservation, or protection of the facility, this provision also relates to depreciation and losses realized on certain sales of entertainment facilities.

Under the bill, if a facility is used more than one-half for business entertaining, so that more than one-half of the entertainment expense with respect to such facility would be deductible as a business expense under present law, that portion would continue to be deductible to the extent it meets the test of being directly related to (or associated with) the active conduct of the taxpayer's trade or business. If less than one-half of such entertainment expense would be deductible under present law, no deduction would be allowed. For example, if the taxpayer acquires a fishing camp which he uses almost exclusively for entertaining business guests, deduction of the expenses of the camp will be disallowed only to the extent that it was used for personal or other nonbusiness purposes. On the other hand, if he uses it almost exclusively for personal purposes, but occasionally takes business guests to the camp, no deduction is to be allowed. A further illustration of this rule is as follows:

> A. The taxpayer corporation claims the purpose of maintaining a resort residence is to have a place available for business conferences. The resort residence has facilities for boating, fishing, and entertainment. It was established that the personal convenience, pleasure, and health of the chairman of the board of the taxpayer corporation was the principal reason for maintaining the residence. However, the evidence did indicate that there was some entertainment expense incurred for business purposes and a portion of the expense was therefore allowed.

Under the bill no deduction would be allowed in the foregoing example because the facts established that the primary use of the resort residence was not in furtherance of the taxpayer's trade or business.

Under this provision the facility must actually be used in furtherance of the taxpayer's trade or business; it is not sufficient that the facility is merely "available" for business use. And where the facility is one which is likely to serve the personal purposes of the taxpayer, it will be presumed that the facility was primarily used by the taxpayer for his personal purposes. To justify a deduction under such circumstances the taxpayer will have to clearly establish that the primary

use of the facility was not for his personal purposes but was directly related to or associated with the active conduct of his trade or business. The following example illustrates the operation of this rule:

B. Closely held corporate taxpayer located in midwest maintains a summer home in Maine. Principal stockholder and wife spend 2½ months each summer at the Maine home and entertained high officials (and wives) of customers.

Under existing law the taxpayer in this case established that the summer home was used partly for business entertainment and was permitted to deduct a portion of the expenses attributable to the summer home. Under the bill, however, because the personal purposes of the principal stockholder are served by use of the corporation's summer home, it will be presumed that his personal purposes were primarily served by such use.

These rules will prevent tax abuses involving the use of luxury facilities for entertainment, amusement, or recreational purposes. Under these rules a taxpayer who lives in a luxurious apartment and who presently deducts a portion of its rent on the ground that the apartment is used for occasional entertaining of business guests (and thus has a business purpose), no longer will be able to deduct any portion of the rent because the principal purpose of the apartment is personal, rather than business. Moreover, a swimming pool constructed at the taxpayer's residence may not be charged off for tax purposes as an ordinary and necessary business expense because such a facility is presumed to be used primarily for personal, family or living purposes unless the taxpayer can establish by a preponderance of the evidence that it was used principally in connection with his trade or business.

As in the case of activities described above, no deduction will be permitted for lavish or extravagant expenses incurred with respect to facilities. This means that luxurious resort facilities maintained for the purpose of entertaining will no longer be fully deductible. This rule is illustrated as follows:

C. Taxpayer, a domestic manufacturing corporation, owns luxurious facilities on a subtropical island. The principal use of the property is for entertainment of executives and key personnel of customer firms. Fishing cruisers are maintained and air transportation furnished guests. The chairman of the board, who is the controlling stockholder, and other officers and key employees accompanied by their families spent considerable time at the island.

Under existing law the entire amount expended for maintenance of the resort and the airplanes (other than adjustments for amounts considered personal expenses of officers and employees) is deductible. Under the bill no deduction would be allowed for any expense which under the circumstances is either lavish or extravagant. Moreover, no deduction will be allowed with respect to expenses attributable to a member of the customer's (present or potential) family but the family's use of the facility will be considered in determining whether the use of the facility is primarily for personal purposes. In addition, as indicated in the portion of this report describing the deductibility of expenses for entertainment activities, expenses for vacations for customers may not be deducted. Where the expenses with respect to the facility are for "vacations," they will be disallowed under your committee's bill.

Club dues and fees paid to any social, athletic or sporting club or organization are treated by the bill as an expense with respect to a facility used for entertainment and therefore will not be deductible where the primary use of the club facilities is personal. If membership entitles the member's entire family to use the facilities of the club, their use as well as his will be considered in determining whether business use of the club exceeds personal use. Where the primary use of the club facilities is in furtherance of a trade or business the cost of the club dues or fees will be deductible to the extent of the use directly related to (or associated with) the active conduct of business. Thus, if membership in a club costs $100 per year and the club is used for such clear business purposes three-fourths of the time, $75 will be deductible. As in the case of other facilities, it is the actual use of the club which establishes the deductibility of the club dues, not its availability for use, and not the taxpayer's principal purpose for joining the club. However, this does not mean that out-of-pocket business entertainment expenses incurred at a club will not be deductible where the required relationship between the entertainment and the taxpayer's trade or business is shown to exist. Such expenses will be deductible under the rules applicable to entertainment activities without regard to the tax treatment of club dues.

Club dues for this purpose do not include dues or fees paid for membership in such civic organizations as Kiwanis, Lions Club, Rotary, Civitan, and similar groups because these organizations are not social, athletic or sporting clubs. Similarly, professional associations such as bar associations and medical associations are not considered social, athletic or sporting clubs. Deductibility of these dues will not be affected by the new rules of this bill, but will continue to be governed by the rules of existing law.

3. Business gifts.—Under the bill, deduction for business gifts will be disallowed to the extent that the total gifts during the year exceed $25 with respect to any person. Where gifts are made to the wife of a man who has a business contact with the donor, these gifts are considered as made indirectly to the husband (for purposes of the limitation).

However, your committee has modified the definition of "gift" contained in the House provision so that items of a clear advertising nature which cost $4 or less will not be required to be taken into account in applying the $25 limitation. The purpose of this modification is to assure that businessmen who advertise their products or services by means of gifts of small value, commonly described as specialty advertising, may continue to do so without being burdened with the maintenance of detailed records of the amount of specialty advertising used with respect to each business prospect. This exception which includes such items as pens, desk sets, and plastic bags and cases, will apply only if the donor's name is clearly and permanently imprinted on the article.

Another modification of the definition of "gift" involves items such as signs, display racks, or other promotional material donated to a retailer by a producer or wholesaler for use on the business premises of the retailer. This material, generally referred to as point-of-purchase advertising, is not a gift; it is simply a form of advertising used right in the store to aid in the marketing process. As in the case of specialty advertising referred to in the preceding paragraph,

this exception for point-of-purchase promotional devices used in normal business operations will eliminate the necessity of manufacturers or wholesalers (who donate the promotional material to retailers) maintaining detailed records and accumulating costs of promotional material with respect to each donee.

The third modification of the definition of "gift" excludes items of tangible personal property which have a cost to the taxpayer of $100 or less if the item is awarded to employees by reason of length of service or for safety achievement. It is a common practice of many employers to give such items as pins or watches to employees upon their completion of a specified number of years of satisfactory employment or in recognition of some safety achievement. Your committee felt that gifts for these purposes which serve to strengthen the relationship between business and its employees should not be discouraged by the tax law. This exception will permit the practice to continue under the rules of existing law.

There is the possibility of overlapping application of the entertainment expense and gift provisions in this new section. An item which might be held to be a gift might also be held to be an entertainment expense. For example, tickets to a theater might fall in either category. Since different rules will apply depending upon the category in which the expense item falls, specific regulatory authority is given to the Secretary of the Treasury or his delegate to prescribe, in cases where both provisions would otherwise apply, which provision is to govern. Thus, a "gift" of theater tickets probably would be classified as coming under the entertainment provision, while a book probably would be classified as coming under the gift provision.

4. Allocation of traveling expenses.—Your committee has added to the House bill a provision which will require taxpayers to allocate traveling expenses (including meals and lodging) between the portion of a trip which is for a business purpose and the portion which is for pleasure. This new rule will eliminate, in many cases, the "but for" rule of existing law under which a taxpayer is permitted to deduct his entire traveling expenses (even where a substantial portion of the time away from home is for purely personal purposes) if he is able to establish that the primary purpose of the trip was connected with a trade or business. This amendment will eliminate abuses whereby taxpayers often arrange vacations to coincide with a business trip so that they thereby, in effect, obtain a deduction for the vacation travel. However, to insure that this new rule will not impose unreasonable burdens on taxpayers to allocate trips between business and personal purposes where the duration of travel is only for a short period, your committee has provided that the allocation rule is not to apply where the period the taxpayer is away from home does not exceed 1 week, or where the time spent on the personal portion of the trip is less than 25 percent of the entire period the taxpayer is away from home on the trip. Where no allocation is required to be made, deduction of traveling expenses will continue to be governed by the primary purpose test of existing law.

5. Disallowance of expenditures not substantiated.—Under the bill, taxpayers will be required to substantiate their entertainment and related expenses, their traveling expenses and gift expenses. The bill provides that the taxpayer must substantiate by adequate records or by other sufficient evidence corroborating his own statement: the

amount of such expense or other item; the time and place of the travel, entertainment, amusement, recreation, or use of the facility, or the date and description of the gift; the business purpose of the expense; and the business relationship to the taxpayer of the person entertained, using the facility, or receiving the gift.

This provision is intended to overrule, with respect to such expenses the so-called *Cohan* rule. In the case of *Cohan* v. *Commissioner*, 39 F. 2d 540 (C.A. 2d, 1930), it was held that where the evidence indicated that a taxpayer had incurred deductible expenses but their exact amount could not be determined, the court must make "as close an approximation as it can" rather than disallow the deduction entirely. Under your committee's bill, the entertainment, etc., expenses in such a case would be disallowed entirely.

The requirement that the taxpayer's statements be corroborated will insure that no deduction is allowed solely on the basis of his own unsupported, self-serving testimony. However, the degree of corroboration required to support a claimed deduction will vary as respects the business relationship and purpose, the time and place, and the amount of the expense. Thus, oral testimony of the taxpayer together with circumstantial evidence available, may be considered "sufficient evidence" for the purpose of establishing the business purpose required under the new provision. However, oral testimony of the taxpayer plus more specific evidence would be required to be "sufficient evidence" as to the amount of an expense.

Generally, the substantiation requirements of the bill contemplate more detailed recordkeeping than is common today in business expense diaries. However, a clear, contemporaneously kept diary or account book containing information with respect to the date, amount, nature and business purpose of the expense may constitute an adequate record under this provision. Moreover, expenditures merely incidental to entertainment, travel, etc. (such as taxicab fares, tips, and similar payments) will be deductible if they are substantiated by such a diary, account book, or similar record.

The following example illustrates the operation of the requirements of this provision: Taxpayer establishes that he traveled from California to New York on business. He should retain receipts for his transportation and hotel expenses while in New York. However, expenses incidental to that trip such as taxicab fares, tips, business luncheons, etc. could be substantiated by entries in a diary.

Your committee does not intend by this substantiation requirement to deny a taxpayer deductions for entertainment, etc., expenses where he has no records if it can be shown that the failure to produce substantiating records was due to circumstances beyond his control, such as destruction of his records by fire or flood. In such a case, the taxpayer will be permitted to reconstruct the business entertainment, travel, or gift expenses incurred by him in the taxable year.

Under the bill, the Secretary or his delegate may, by regulation, prescribe certain situations in which the substantiation requirements will not be applied. For example, it may be provided that substantiation will not be required for traveling expenses, where such expenses (including the cost of meals and lodging) do not exceed prescribed minimum amounts. This will be of special benefit to employees whose per diem allowance while traveling is within limits established by the Secretary under this provision. Thus, if regulations are

issued under which substantiation will not be required for traveling or entertainment expenses where per diem allowances do not exceed 125 percent of per diem allowed a Government employee in the same locality, it would be sufficient evidence for purposes of the substantiation rule to establish only the amount of the allowance and the fact that the business travel occurred.

6. *Exceptions where disallowance provisions will not apply.*—The bill contains nine exceptions to the general disallowance provision described above under heading 1 or 2. Where an expense falls within one of the enumerated exceptions, the item will continue to be deductible to the same extent as allowed by existing law. However, the new substantiation requirements (discussed under heading 5) will have to be satisfied with respect to any such expense. The exceptions are as follows:

(*a*) Expenses for food and beverages furnished under circumstances which are of a type generally considered to be conducive to a business discussion. The question as to whether the circumstances are conducive to a business discussion are to be tested by such standards as: First, the surroundings in which the meal or beverage was furnished; second, the taxpayer's trade or business or income-producing activity; and third, the relationship to such trade, business, or activity of the persons to whom the food and beverages were furnished. Under this exception, the general custom of entertaining business guests at meals in restaurants and hotels would not be disallowed if they meet the ordinary and necessary test of existing law. This should leave undisturbed the most significant portion of goodwill entertainment conducted in this country. However, under this exception, it will not be possible to deduct luncheon expenses of a so-called reciprocity luncheon group under which a group of businessmen frequently lunch together and alternate in paying the check (and claiming it as a business expense deduction). This practice is not connected with a trade or business but is a personal or social expenditure which is not deductible under existing law.

(*b*) Expenses for food and beverages (and facilities used in connection with them) furnished on the business premises of the taxpayer primarily for his employees. This is intended to exclude from the disallowance provision such facilities as a company cafeteria or an executives' dining room. This exception would continue to apply even though guests are occasionally served in the cafeteria or dining room.

(*c*) Goods, services and facilities to the extent that the entertainment, amusement, or recreation (or use of the facility) is treated on the taxpayer's return with respect to the recipient of the entertainment as compensation paid to an employee and from which income tax is withheld. For example, if the taxpayer permitted an employee to use a yacht for a vacation and treated the expenses for its use as compensation paid to the employee for purposes of the withholding tax and for purposes of the taxpayer's tax return, maintenance and crew costs attributable to such use would be deductible in full because of this exception. On the other hand, where a yacht was used exclusively for business entertaining the salaries paid to the captain and crew, even though they were treated as compensation and withheld on, would not

come within this exception because they are not the recipients of the entertainment. Rather, the deductibility of the salaries would be determined under the general rule of the provision as an expense with respect to an entertainment-type facility.

(*d*) Expenses paid or incurred by the taxpayer where he pays or incurs the expenses for his employer or a client, customer, etc., and where he is reimbursed by the employer or client, etc. This is designed to prevent the double disallowance of a single expenditure, once to the employee or practitioner, etc., and a second time to the employer or client, etc. This provision will not apply, however, in the case of an employee where the employer treats the amount paid to him as compensation. It also will not apply in the case of a practitioner, etc., unless he accounts to the client, etc., for the expenses incurred. The accounting must represent sufficient substantiation to meet the tests set out under heading No. 5. Thus, if a lawyer enters into a fee arrangement under which his client agrees to reimburse him for expenses (including entertainment expenses) the exception will not apply unless he accounts to his client sufficiently to enable the client to substantiate the expenses as required by the bill.

(*e*) Expenses incurred for recreation, social, or similar activities (including facilities) primarily for the benefit of employees. The employees referred to in this case are those, other than officers, shareholders, or highly compensated employees. An individual would be considered a shareholder only if he (taking into account holdings of members of his family) holds an interest in the corporation of 10 percent or more. This category is intended to pertain to the usual employee fringe benefit programs, such as expenses of operating a company swimming pool or baseball diamond, as well as the expenses of the annual company picnic or Christmas office party.

(*f*) Expenses directly related to business meetings of the taxpayer's employees, stockholders, agents, or directors. While this category will apply to business meetings where some social activities are provided, it is not intended to apply to gatherings which are primarily for social purposes rather than for the transaction of the employer's or company's business.

(*g*) Expenses directly related and necessary to attendance at a business meeting of an organization, such as a trade association, chamber of commerce, real-estate board, etc., described in section 501(c)(6) of the code.

(*h*) Expenses for goods, services, and facilities made available to the general public by the taxpayer. This pertains to expenses for the entertainment of the general public by means of television, radio, newspapers, and the like. It also permits deductions for expenses for parks, etc., maintained by companies where the general public may attend. Expenses of distributing samples to the general public would also come within this exception.

(*i*) Expenses for goods or services (including the use of facilities) which are sold by the taxpayer in a bona fide transaction for an adequate and full consideration in money or money's worth. This exception is designed to insure that a taxpayer who sells entertainment to others will be allowed to deduct expenses of producing that entertainment. Thus salaries paid to employees

of nightclubs and amounts paid to performers other than employees will continue to be deductible by the operator. Moreover, since this type of expense is not considered to be "entertainment" the detailed substantiation requirements prescribed in this bill will not apply.

7. *Interest, taxes, casualty losses.*—The restrictions provided by the bill are not to apply with respect to items which are deductible under specific provisions of law which apply both to business and nonbusiness taxpayers. Thus, deduction for interest paid on a loan to acquire an entertainment facility or property taxes paid with respect to it would continue to be allowed as a deduction, whether or not the entertainment facilities meet the tests of the new provision.

8. *Treatment of entertainment-type facilities.*—Under the bill, if deductions with respect to entertainment-type facilities are disallowed, the disallowed portion is to be treated as an asset which is used for personal, living, and family purposes, rather than as an asset used in the trade or business. Under this provision the basis of such an entertainment-type facility will be adjusted for purposes of computing depreciation deductions and determining gain or loss on the sale of such facility in the same manner as other property (for example, a residence) which is regarded as used partly for business and partly for personal purposes. Thus, if a taxpayer has a yacht which is used three-fourths for direct business entertainment purposes, and he ordinarily would be entitled to $1,000 for depreciation with respect to the yacht (if it were used entirely for business), $250 of this amount would be disallowed as a depreciation deduction and would be included as a part of the basis of an asset not used in the taxpayer's business.

9. *Meals and lodging while in travel status.*—The bill, as amended by your committee makes clear that the deduction provided for traveling expenses by section 162(a)(2) of present law is not to include expenses for meals and lodging which are lavish or extravagant under the circumstances.

10. *Effective date.*—The amendments made by this provision are to apply with respect to taxable years ending after December 31, 1962, but only in respect of periods after that date.

V. DISTRIBUTIONS IN KIND BY FOREIGN CORPORATIONS

(Sec. 5 of the bill and sec. 301 of the code)

A. Reasons for provision

Under present law, when a distribution in kind is made by a corporation to a shareholder which is also a corporation, the amount which is treated as a distribution is the fair market value of the property received or, if lower, the adjusted basis of the property in the hands of the distributing corporation. Where both the distributing corporation and its corporate shareholder are domestic corporations, taking into account the adjusted basis when it is lower than the fair market value of the property may be justified on the grounds that the appreciated property is still owned by a corporation and, in fact, very little has happened. Furthermore, if the distributee corporation sells the property, the same amount of gain will be realized and taxed as if the distributor corporation had sold it. Where the distributing corporation is a foreign corporation, however, the device of distributing

to its U.S. corporate shareholder property which has appreciated in value can be used as a device to permit the U.S. corporation to realize on the earnings and profits of the foreign corporation at minimum U.S. tax. Assume, for example, that an American parent has a 100-percent owned foreign subsidiary. This foreign subsidiary has $100,000 in accumulated earnings and profits resulting from foreign earnings, all of which enjoyed complete deferral from U.S. tax. Assume further that the foreign subsidiary is in a position to distribute to its American parent either $50,000 in cash or a property having a fair market value of $50,000 but an adjusted basis of only $20,000. Under existing law, the dividend income to the American parent is $50,000 if the cash is distributed but is only $20,000 if the property is distributed. Under the amendment provided by this bill, however, the dividend income to the parent is the same amount ($50,000) whether the cash or the property is distributed. This result is believed appropriate since the increase in value of the parent's assets is the same whether it receives the cash or the property.

B. Comparison of committee amendment with House provision

Your committee has retained the House provision with one modification. It has deleted the subsection in the House bill which, only for purposes of computing the allowable foreign tax credit, treats as the amount of the distribution the adjusted basis of the property which is distributed (where this is less than its fair market value). Your committee believes that since the distribution itself is to be taken into account at its fair market value, it would only be appropriate for purposes of determining the foreign tax credit, allowable with respect to this same distribution, to treat this distribution as sharing in the creditable foreign taxes in proportion to the fair market value of the distribution, rather than in proportion to its adjusted basis as under the House bill. This will maintain the current practice with respect to the valuation of the distribution, for purposes of allowing a foreign tax credit, in the case of those distributions in kind which under existing law already are taxed to the corporate recipients only at their fair market value.

C. General explanation of provision

This provision amends existing law (sec. 301(b)(1)(C)) to provide that where there is a distribution in kind from a foreign corporation and the shareholder is a corporation, then the amount of the distribution for dividend purposes is to be the fair market value of the property distributed, and not its adjusted basis in the hands of the distributor where that is lower.

An exception to the rule described above is provided where the distributing corporation, although a foreign corporation, during the 3 years ending with the close of the corporation's taxable year derived more than 50 percent of its income from sources within the United States. In such cases, to the extent that the income is subject to U.S. tax, the corporation receiving the dividend can continue to apply the rule generally available for domestic corporations. Thus, to the extent the dividend is treated as eligible for the 85-percent dividends received deduction, the amount of distribution will be the adjusted basis of the property to the distributing corporation where this is lower than its fair market value.

Your committee's amendment differs from the House bill in that, in computing the foreign tax credit allowable with respect to the distribution in kind, the distribution is to share in the creditable foreign taxes on the basis of its fair market value rather than in proportion to its adjusted basis, where this is lower. This continues the rule in present law which is that the amount considered to be a dividend also is the amount taken into account for purposes of allowing a foreign tax credit.

The bill also makes appropriate basis adjustments to take into account the changed rules with respect to dividend distributions.

The amendments made by this provision are to apply to distributions made after December 31, 1962.

VI. MUTUAL SAVINGS BANKS, ETC.

(Sec. 6 of bill and secs. 593, 595, and 7701(a) of code)

A. Reasons for provision

Until 1952 mutual savings banks, domestic building and loan associations, and certain cooperative banks (hereinafter referred to as mutual savings institutions) were exempt from Federal income tax. This exemption had initially been based upon the premise that the members' money in the case of these institutions was being used for loans to members, or that the institutions were in effect doing business with themselves and that since the earnings of the institutions belonged to the depositors rather than to them, there could be no profit on which to impose an income tax.

In 1951, however, Congress repealed the exemption of these mutual savings institutions and subjected them to the regular corporate income tax. At the same time, however, these institutions were allowed a special deduction for additions to bad debt reserves which proved to be so large that they have remained virtually tax exempt since 1951. The 1951 legislation provided that deductions could be made for additions to a reserve for bad debts in whatever amount the institution deemed appropriate so long as (1) the amount set aside each year did not exceed the taxable income (before this deduction) of the institution for the year, or (2) its total reserves and surplus did not exceed 12 percent of its deposits or withdrawable accounts at the close of the year.

The President, in his tax message of April 20, 1961, observed that—

> Some of the most important types of private savings and lending institutions in the country are accorded tax deductible reserve provisions which substantially reduce or eliminate their Federal tax liability.

He further stated that—

> These provisions should be reviewed with the aim of insuring nondiscriminatory treatment.

The Secretary of the Treasury in his appearance before your committee stated:

> Under present law, mutual savings banks and savings and loan associations can deduct from their income amounts added to a reserve for bad debts until reserves, surplus, and

undivided profits equal 12 percent of deposits or withdrawable accounts. As a result, during the entire decade, 1952–61, all mutual savings banks and savings and loan associations paid total Federal income taxes of less than $70 million, while at the same time they retained $5.5 billion as additions to reserves, surplus, and undivided profits. From an economic and accounting point of view a large part of the untaxed additions to bad debt reserves constitutes net income which, were it earned by competing financial institutions, would be subject to corporate income tax.

Your committee has reviewed the tax treatment of the mutual savings institutions. It agrees with the House that the present bad debt reserve provisions are unduly generous and that they require revision.

B. Comparison of committee amendments with House provision

Your committee has retained the basic House provisions relating to deductible reserves for these mutual savings institutions but has reduced the reserve deduction for stock companies and has made a number of relatively minor modifications in the generally applicable reserve provisions which in large part are designed to restrict the reserves available. In addition, it has provided a new definition of domestic savings and loan associations, has removed certain excise tax exemptions presently available to these institutions, and made another amendment relating to the deduction of dividends paid to depositors.

The House bill amends the special bad debt provisions of existing law which are applicable to these mutual savings institutions to provide that they may add to these reserves for bad debts each year whichever of the following is the greatest:

(1) 60 percent of taxable income for the year computed before a bad-debt deduction,

(2) An amount sufficient to bring the balance of the reserve for losses on qualifying real property loans to 3 percent of such loans outstanding at the close of the taxable year, plus an amount sufficient to bring the balance of the reserve for losses on other loans to a reasonable amount, or

(3) If an institution demonstrates a need for a reserve greater than is permissible under (1) or (2), an amount sufficient to bring the overall balance of its reserves to a "reasonable" amount.

Your committee has amended the 60 percent of taxable income reserve addition referred to in No. (1), above, to provide that the the amounts added to the reserve under this provision may not increase the reserve for losses on qualified real property loans to more than 6 percent of these loans. This amount, which is double the 3 percent referred to in No. (2), above, in your committee's estimation should provide an adequate protection against losses. Therefore, the deduction of any amount in excess of this is believed inappropriate.

Your committee also has adopted an amendment to provide that the deduction allowable under any of the three alternatives referred to above is not to be allowed to the extent it would increase the reserve for losses on qualifying real property loans together with the reserve for losses on nonqualifying loans and surplus, undivided profits, and reserves attributable to years beginning both before and after December 31, 1951, to more than 12 percent of total deposits or

withdrawable accounts. This 12-percent limitation is substantially the same as the restriction in existing law and has been added by your committee to give assurance that these mutual savings institutions will in no event receive deductions for building up reserves in excess of those allowable before the enactment of this bill.

The House bill provided that the reserve for losses on qualified real property loans at the end of 1962 was to be established out of existing reserves up to a level of 3 percent of the qualifying loans outstanding at that time. For this purpose only those reserves were to be taken into account which were attributable to years beginning after December 31, 1951, the year when these savings institutions first became taxable institutions. Your committee has concluded, however, that it is appropriate to take into account pre-1952 reserves to the extent necessary to obtain a 3-percent beginning reserve. In this regard it should be noted that Congress when it first made these institutions taxable in 1952 specified that the reserves then set up were to be made with "due regard" to the pre-1952 reserves. Your committee's amendments likewise provide that these reserves are to be taken into account for purposes of establishing the 3-percent reserve. However, recognizing that these amounts are attributable to periods before these institutions were taxable, your committee's amendments provide that these pre-1952 reserves are to be taken into account only in determining the balance in the reserve. Thus, if the institution believes that the reserves it needs are less than this 3 percent then, to the extent pre-1952 reserves were taken into account, these funds may be distributed to depositors or used for other purposes without tax effect. However, in applying the 3-percent limitation (in determining whether deductions are allowable) such amounts will be treated as if they were still in the reserve.

Your committee, recognizing the greater hazards of a new business, concluded that the 3-percent level of reserves, previously referred to, should appropriately be increased to 5 percent with respect to the first $4 million of loans (a maximum increase in the reserves of $80,000) during the first 10 years of mutual savings institutions' existence. This amount is not to be available to stock savings and loan associations.

Your committee has also considered the fact that stock savings and loan institutions, although having many of the same characteristics as the mutual savings and loan associations are, nevertheless, commercial enterprises more nearly comparable to banking institutions than are the mutual associations generally. For that reason, although these associations are generally allowed the same treatment as the mutual savings institutions, your committee concluded that it was appropriate to provide a somewhat lower maximum addition to reserves in the case of the stock companies. For that reason, it is provided that 50 percent of taxable income instead of 60 percent is the maximum addition to reserves that such companies may make under alternative No. (1) referred to above.

Your committee also has provided a new definition of domestic building and loan associations. The definition appearing in the House bill in general provided that substantially all of the business of the institution must consist of accepting savings and investing the proceeds in loans secured by residential real property and other loans to the extent authorized to be made by a Federal savings and loan

association under the Home Owners Loan Act. Your committee was concerned with the application of this definition because of the uncertainty as to what might be considered investing substantially all of the proceeds in residential real property. It also doubted the desirability of permitting the tax status of these institutions to turn, in part at least, upon the types of investments allowed them under the Home Owners Loan Act, which has different standards for determining allowable investment. In view of these considerations your committee has provided a more specific definition which, nevertheless, continues to require these institutions to devote most of their proceeds to home loans.

The definition provided by your committee in general provides that 90 percent of the total assets of the institution must be invested in loans secured by an interest in real property (or for certain other closely associated uses). It further provided that of this 90 percent of total assets, at least 80 percent (72 percent of total assets) must be invested in residential real property. Furthermore, 70 percent of this 90 percent (63 percent of total assets) must be invested in residential real property containing four or fewer family units. It is recognized that an institution may under special circumstances not be able to obtain loans on real property, residential real property or 1- to 4-family unit residential real property. Therefore, the new definition provides that cash and Government obligations to a limited extent may also qualify under any of the percentage requirements specified above. It is not intended, however, that cash or Government obligations be used as a means of expanding nonresidential loans beyond the difference between the 72 percent of total assets and the 90 percent of total assets (except to the extent cash and Government bonds are less than 10 percent of total assets) nor is it intended to permit the expansion of other than 1- to 4-unit residential loans beyond the difference between the 63 percent of total assets and the 90 percent of total assets (again except to the extent that the cash and Government obligations are less than 10 percent of total assets). Therefore, although the cash and Government obligations may be taken into account in determining qualification under the 72 percent or 63 percent limitations, this cannot be done in a manner which permits the expansion of the otherwise nonallowable loans above the difference between the 72 percent and 90 percent (namely, 18 percent of total assets for other than residential loans and cash and government obligations) or the difference between the 63 percent and 90 percent (namely, 27 percent of total assets for other than for 1- to 4-family residential unit loans and cash and Government obligations), except to the extent that the cash and Government obligations are less than 10 percent. Also included are tract loans where the proceeds of the loan will be used for any of the categories specified, interests in such loans and improvements loans which are concerned with such property. In addition, your committee has provided that generally none of the assets of one of these savings institutions may be invested in the stock of any corporation other than that of an instrumentality of the United States or of a State or its political subdivision.

The House bill repealed exemptions granted Federal savings and loan associations from excise taxes on communications, and on transportation of persons. Your committee is in accord with the repeal of these exemptions but in addition has provided for the repeal of

exemptions from documentary stamp taxes provided for these savings institutions. However, it is made clear that the documentary stamp tax on the insurance or transfer of shares of stock is not to apply in the case of shares or certificates representing deposits or withdrawable accounts, which are comparable to bank accounts where no documentary stamp tax is applicable.

The final amendment made by your committee provides that dividends and interest paid by savings institutions which are chartered and supervised as savings and loan or similar associations under Federal or State law are to be deductible to the institution in computing its income subject to tax in the same way as interest on deposits is deductible to commercial banks. This is to be true whether or not the savings institution meets the definition provided by the tax law of a "domestic building and loan association."

C. General explanation of provision

1. Additions to reserves for losses on loans.—In the case of mutual savings institutions the bill provides new rules for calculating the deduction allowable for additions to bad-debt reserves, or "reserves for losses on loans" as they are referred to in the bill. Beginning in 1963, these institutions will maintain two accounts to which additions will be made in the future with respect to reserves for bad debts.[1] One of the two accounts is a reserve for "losses on qualifying real property loans," the additions to which can be determined by the taxpayer under rules set forth in the bill. The other is a reserve for "losses on nonqualifying loans."

Additions to this latter account are required to be "reasonable additions," which means that, as in the case of other taxpayers, additions to these reserves will be determined upon the basis of the past experience and other appropriate factors.

In the case of the reserve for losses on qualifying real property loans, the addition to be made each year to this reserve is to be determined by the taxpayer but may not exceed whichever of the following is the largest:

(*a*) 60 percent of the institution's taxable income for the year computed before this deduction (minus the amount added to the reserve for losses on nonqualifying loans). This may not exceed an amount necessary to increase the balance of the reserve for losses on qualifying real property loans to 6 percent of these loans. Also, in the case of stock savings and loan associations, the deduction, instead of being 60 percent of taxable income, is to be 50 percent of this income;

(*b*) the amount necessary to increase the balance in the reserve for losses on qualifying real property loans to 3 percent of such loans outstanding at the close of the taxable year. For new mutual (but not stock) companies (in their first 10 years of existence) this 3 percent is increased by 2 percent, but only with respect to loans not in excess of $4 million (a maximum special reserve addition of $80,000);

(*c*) if the institution demonstrates the need for greater reserves than are permitted under (*a*) or (*b*) above, an amount which would be permitted to be added to the reserve for losses

[1] They may also have a supplemental reserve which will represent certan reserves built up in the period from 1952 through 1962. This supplemental reserve is explained below.

on qualifying real property loans without regard to the special provision for mutual savings institutions.

Your committee's amendments provide that the total amount added to the reserve for losses on qualifying real property loans (determined under (a), (b), or (c) above) plus the amount added to the reserve for losses on nonqualifying loans may not exceed the amount which brings the combined balance of these reserves and surplus, undivided profits and reserves (whether accumulated before or after December 31, 1951), to an amount equal to 12 percent of total deposits (or withdrawable accounts).

When losses on loans are realized they will be charged to the appropriate account within the general reserve for bad debts. That is, losses on loans with respect to qualifying real property will be charged to the reserve for such loans and losses on nonqualifying loans will be charged to the reserve for losses on such loans.[2]

The reserves which are required by the bill to be established—that is, the reserve for losses on qualifying real property loans, the reserve for losses on nonqualifying loans, and the supplemental reserve for losses on loans—are required to be treated as bad-debt reserves for all tax purposes (except that no deduction is allowed for any addition to the supplemental reserve). Thus, although these reserves are termed reserves for "loans," they are reserves for bad debts; and any charge to any such reserve for an item other than a bad debt will result in the inclusion in gross income of an amount equal to such charge.

For purposes of determining annual additions to the reserve for losses on qualifying real property loans, mutual savings institutions are to take into account all loans secured by improved real property (whether such loans are insured or uninsured) except Government bonds, certain corporate obligations and certain loans between banks and related parties. Under this provision, both federally insured FHA and guaranteed VA home loans, as well as conventional loans, may be taken into account in determining the amount of additions to the reserve for losses on qualifying real property loans. Loans on improved real property are intended for this purpose to include loans obtained for the construction of improvements on real property, even though at the time the loan is made no improvements may exist on the property.

The following examples illustrate the operation of the alternative choices for additions to reserves for bad debts:

Example 1: At the close of its taxable year, X, a mutual building association in existence for more than 10 years, has improved real property loans outstanding of $2,000 and nonqualified loans of $200. Its taxable income before any addition to a reserve for bad debts is $50. The balance in its reserve for losses on improved real property loans is $51 and the balance in its reserve for losses on nonqualifying loans is $1. (Its experience indicates the need for a reserve for losses on nonqualifying loans of 1 percent of such loans, and a reserve for losses on improved real property loans of 2.5 percent of such loans.)

For this year X would be permitted to add to its reserves $30 (60 percent times $50). (Under the 3-percent method only $10 could have been added, $1 to the nonqualifying loan reserve and $9 to the qualifying loan reserve.) Of this amount, $1 would be added to the

[2] At the election of the taxpayer, losses on any loan instead of being charged to the reserve referred to above may be charged in whole or in part to the supplemental reserve for losses on loans referred to below.

reserve for losses on nonqualifying loans (making the balance in that account $2) and $29 would be added to the reserve for losses on improved real property loans (making the balance in that account $80). Taxable income for this year would then be $20.

Example 2: Assume the same facts, except that taxable income before any addition to reserve for bad debts is $15. X would be permitted to add to its reserves $10. This is the amount necessary to bring the balance of the reserve for losses on nonqualifying loans to $2 (1 percent times $200) plus the amount necessary to bring the balance of the reserve for losses on improved real property loans to $60 (3 percent times $2,000). (Under the 60-percent method the addition would have been only $9.) Taxable income would then be $5 ($15 minus $10).

2. Treatment of pre-1963 reserves.—At the present time bad-debt reserves, etc., of mutual savings banks on the average are about 10 percent of their deposits, while similar reserves of domestic building and loan associations average about 8 percent of deposits. This means that existing reserves of these mutual savings institutions in most cases will exceed 3 percent of qualifying real property loans, plus a reasonable reserve for other loans.

The bill makes special provision for the treatment of existing bad-debt reserves of mutual savings institutions. If the entire amount of such reserves (called "pre-1963 reserves" in the bill) were required to be allocated to the reserve for losses on qualifying real property loans and to the reserve for losses on nonqualifying loans, the balances of those reserves would in many cases be so large that many mutual savings institutions would be denied a deduction for additions to bad-debt reserves for many years. In order to mitigate this effect, your committee's bill provides that only a portion of such pre-1963 reserves is to be allocated to the reserve for losses on qualifying real property loans and to the reserve for losses on nonqualifying loans, under the following rules:

(*a*) First, there is credited to the reserve for nonqualifying loans whatever portion of these pre-1963 reserves is necessary to bring the balance of this reserve to an amount which would be reasonable on the basis of nonqualifying loans outstanding as of December 31, 1962;

(*b*) Next, there is credited to the reserve for losses on qualifying real property loans whatever remaining portion of the pre-1963 reserves is necessary to bring the balance of this reserve up to 3 percent of loans on improved real property outstanding as of December 31, 1962, or to a greater amount if the experience of the institution as of December 31, 1962, indicates a need for a greater reserve; and

(*c*) Finally, any remaining pre-1963 reserves are credited to the supplemental reserve for losses on loans.

Amounts credited to the supplemental reserve for losses on loans can be used only to offset losses on loans (if the institution chooses to charge losses to this reserve). Any other use of this reserve will result in the inclusion in gross income of the charge. In determining the amount of these pre-1963 reserves the House bill provided that accumulations in reserves were to be taken into account only for years after December 31, 1951. Your committee's amendments provide that pre-1952 reserves also are to be taken into account in establishing

the 3-percent opening balance in the reserve for qualifying real property loans, but that the amount added to the reserves attributable to this pre-1952 period may be distributed to depositors or otherwise used by the institution so long as this amount continues to be taken into account in determining the balance at any time in this fund.

3. Distributions to shareholders.—Some of the savings and loan associations to which this provision is applicable have shares of stock outstanding (which are not withdrawable shares). The bill provides that in the case of distributions to these stockholders, the amounts are to be considered as paid out of the following funds of the institution:

(*a*) First, out of earnings and profits accumulated in taxable years beginning after December 31, 1951;

(*b*) Then out of the reserve for losses on qualifying real property loans (but only to the extent the balance in this reserve exceeds the amount which would have been allowed the institution in the absence of the special reserve provision);

(*c*) Next out of the supplemental reserve for losses on loans; and

(*d*) Finally, out of other amounts.

Before distributions can be made out of either the reserve for losses on qualifying real property loans or out of the supplemental reserve, the amount required to be charged by the stock institution must be included in its gross income for tax purposes. The amount required to be charged to either of these reserves and included in income is the amount of the distribution to the stockholder "grossed-up" by the appropriate amount of tax. These special rules will insure that any amount distributed to stockholders out of amounts charged to these reserves which was not previously taxed will be subjected to the regular corporate income tax at the time of distribution.

4. Foreclosures on property securing loans.—The bill also adds a new provision to the code containing rules to govern the tax consequences of mortgage foreclosures (or other similar proceedings) in which a mutual savings institution takes over property which was security for its loan. Under existing law the foreclosure event is considered a taxable transaction. This has been interpreted to mean that a bad-debt deduction may or may not arise at that time, depending upon the relation of the bid price of the property to the amount of the loan outstanding. Where the foreclosed property is bid in for the amount of the loan a bad debt deduction may not be taken under present law; however, a gain or loss may result at the time of foreclosure if the fair market value of property foreclosed is different from the price at which it was bid in. When the property is subsequently sold by the mutual savings institution, it may realize a further gain or loss on such disposition. Whether the gains and losses at the time of foreclosure and at the time of ultimate disposition are capital or ordinary gains and losses depends on the nature of the activities of the institution at each such time.

The bill seeks to avoid these erratic results by providing that in the future a foreclosure is not to be treated as a taxable event, and that amounts received by the mutual savings institution subsequent to the foreclosure are to be treated as payments on the indebtedness. This would be accomplished under the bill by treating the property received in a foreclosure (or other proceeding) as having the same characteristics as the debt for which it was security. Thus, for bad-

debt (or loss) purposes the act of foreclosure will not create a taxable occasion; however, if the property has depreciated in value, the decline may be charged against the bad-debt reserve as a partially worthless debt. If it continues to decline in value, additional charges may be made against the reserve. When the property is ultimately sold or disposed of, the difference between any amount realized and the original or previously reduced debt, is to be treated as ordinary loss or income and is to be charged, or credited, as the case may be, against the reserve for losses on qualifying real property loans. Because the foreclosed property is to have the same characteristics as the indebtedness, where property is rented by the mutual thrift institution after foreclosure, no depreciation deduction is to be permitted. However, as explained above, if the property actually depreciates in worth (as contrasted to a mere decline in book value), a charge may be made against the reserves.

5. *Definition of domestic building and loan association.*—Under present law "domestic building and loan association" is defined to mean a—

> domestic building and loan association, a domestic savings and loan association, and a Federal savings and loan association, substantially all of the business of which is confined to making loans to members.

Problems have arisen with this definition because loans in many cases now are in substance not loans made to members. It is understood that technical conformance has been maintained with the membership requirement of present law by making borrowers of funds members of the institutions. However, questions have arisen as to the substance of such provisions.

As a result, your committee has concluded that the definition of a domestic building and loan association, eligible for the tax treatment described above, should be brought more nearly into conformance with actual practice. At the same time it was deemed desirable to restrict this tax treatment to those primarily engaged in making residential real estate loans, with special emphasis on 1- to 4-family units, and omitting from the definition cases such as those where these institutions have been used for speculative purposes.

In view of these considerations, your committee has redefined a domestic building and loan association to mean a building or savings and loan association which is an insured institution within the meaning of section 401(a) of the National Housing Act or one which is subject by law to supervision and examination by State or Federal authority having supervision over such associations. In addition, however, the bill provides that an institution in either of these groups qualifies only if substantially all of its business consists of accepting savings and investing in loans secured by or for the improvement of real property of the type described below. This restriction will, of course, prevent such a savings institution from carrying on the business of brokering mortgage paper if this represents any substantial part of its business. It is not intended, however, that this prevent necessary borrowings from Government agencies such as HOLC.

A third restriction on qualified domestic building and loan associations requires them to invest at least 90 percent of their assets in—

(*a*) Cash,

(*b*) Obligations of the United States or of a State or local government and stock or obligations of a corporate instrumentality of the United States or of a State or local governmental unit,

(*c*) Loans secured by an interest in real property including so-called improvement loans,

(*d*) Loans secured by a deposit (or share) of a member, and

(*e*) Property acquired through default of real property loans.

Of the 90 percent of total assets referred to above, at least 80 percent (72 percent of total assets) must be invested in residential real property loans (including improvement loans for such property and tract loans which will be used for such property) or in cash or Government obligations (referred to in (*a*) and (*b*) above). In addition, at least 70 percent of this 90 percent of total assets (63 percent of total assets) must be invested in residential real property representing 1- to 4-family units (or loans made for the improvement of such property or tract loans on such property) or in cash or Government obligations (as referred to in (*a*) and (*b*) above). The bill also provides that no more than 18 percent of the total assets of an association may be invested in other than residential real property loans, cash, and Government obligations except to the extent that cash and governmental obligations are less than 10 percent of total assets. Similarly the bill provides that no more than 27 percent of the total assets may be invested in other than 1- to 4-family-unit residential real property loans, cash, and Government obligations, again except to the extent that cash and Government obligations are less than 10 percent of total assets. One further requirement provides that none of the assets of the association may be invested in stock of any corporation other than stock of a corporate instrumentality of the United States, a State or local governmental unit, or stock acquired through defaults.

6. *Repeal of certain excise tax exemptions.*—Under present law, Federal savings and loan associations are exempt from the excise taxes on communications and the excise tax on transportation of persons. These exemptions were granted by the Home Owners' Loan Act of 1933. Your committee's version of the bill repeals these exemptions effective as of December 31, 1962. In addition, the amendments made by your committee delete the exemptions from the documentary stamp taxes on stocks and certificates of indebtedness under existing law in the case of domestic building and loan associations, savings and loans associations, cooperative banks, and homestead associations. The exemption from the stock issuance or transfer taxes is continued, however, in the case of domestic building and loan associations and cooperative banks insofar as these taxes relate to stock representing deposits or withdrawable accounts.

7. *Deduction for dividends paid on deposits.*—Your committee has also provided for a deduction for dividends or interest paid by savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law even though they do not come within the definition of domestic building and loan associations. This deduction is available only in the case of amounts paid to depositors or those having withdrawable accounts.

8. *Effective date.*—The new rules provided by the bill for additions to reserves for bad debts are to apply to taxable years ending after December 31, 1962. However, the bill provides a special rule to deal with fiscal years where a taxpayer has a year which begins in 1962

and ends in 1963. The effect of this special rule is to continue the rules under existing law up to the end of December 1962, and to apply the new rules as of January 1, 1963.

The tax treatment provided for property acquired in mortgage foreclosure proceedings is to apply to transactions occurring after December 31, 1962, in taxable years ending after that date. The new definition of domestic building and loan associations is to be effective for taxable years beginning after the date of the enactment of the bill. The repeal of the exemptions from excise taxes on communications and on transportation of persons in general is made effective as of January 1, 1963.

VII. DISTRIBUTIONS BY FOREIGN TRUSTS

(Sec. 7 of bill and secs. 643, 665, 666, 668, 669, 6047, 6677, and 7701 of code)

A. Reasons for provision

Certain tax avoidance possibilities exist under present law in connection with foreign accumulation trusts created by U.S. citizens or residents. The avoidance device involves the establishment of trusts for the benefit of U.S. beneficiaries by a U.S. grantor (or settlor) in a foreign country where the income of such trust is subject to little or no tax. The trust corpus may consist of foreign securities so that the income can be accumulated in the trust free of any U.S. tax for any number of years. In addition since these trusts are formed in countries which impose little or no tax on such income, no tax at all is likely to be paid. When the trust terminates and distributes the accumulated income and corpus to the U.S. beneficiaries, such distributions may be subject to no U.S. tax, or be subject to tax on only a small portion of the distributions.

Under present law, where a domestic trust is established for the purpose of accumulating income for a period of years the trustee pays a tax currently on the income accumulated at the same rates applicable to individuals. In general, when a beneficiary receives a distribution from the trust, in excess of the currently distributable net income (if the amount exceeds $2,000), it is taxed to him to the extent it represents income accumulated by the trust in any of the preceding 5 years. The tax on such amounts is payable currently, but is computed as if the beneficiary had received a distribution of this income in each of these 5 prior years in which the income was earned, with a credit being allowed for the taxes paid by the trust with respect to such income.

The above rule, known as the "5-year throwback rule", is also applicable to distributions made by foreign trusts to U.S. beneficiaries. However, it frequently does not result in a tax on the distributions. First of all, it does not in any case apply to any income accumulated for more than 5 years. In addition, there are a number of exceptions making distributions nontaxable to the beneficiaries even where they are attributable to the 5 immediately preceding years. For example, the 5-year throwback rule does not apply to accumulations for the benefit of a minor beneficiary; accumulations distributed to a beneficiary upon reaching a specified age if not more than four such distributions can be made or the distributions are at least 4 years apart; and distributions to a beneficiary where a trust terminates and makes a

final distribution which occurs more than 9 years after the date of the last transfer to the trust. As a result of these exceptions, and the 5-year limitation, it is relatively easy for U.S. grantors or settlors to establish foreign trusts in such a way that they pay little or no tax on trust income and which upon termination make distributions to American beneficiaries with little or no U.S. tax being paid.

In the last Congress, a bill (H.R. 9662) which was passed by the House, but on which action was not completed by the Senate, contained an amendment added by your committee designed to discourage the creation of foreign trusts for the purpose of avoiding U.S. tax. In addition, the Secretary of the Treasury in testimony last year recommended that with respect to existing trusts the law be modified so that distributions to a U.S. beneficiary from a foreign trust would be subject to tax in the year of distribution in an amount equal to the tax which would have been imposed had the income been distributed currently. This is in effect an extension of the existing 5-year throwback rule.

In view of the existing avoidance possibilities with respect to these foreign trusts, your committee agrees with the House that American beneficiaries of foreign trusts created by U.S. grantors, settlors or transferrors should be taxed in substantially the same manner as if the income had been distributed to the beneficiary currently as earned (although a "shortcut" method of computation may be elected by the taxpayer in place of this more "exact" method). This provision is not viewed by your committee as imposing a penalty but rather as a method for placing U.S. beneficiaries of foreign accumulation trusts created, or added to, by Americans in substantially the same way as the beneficiaries of domestic trusts distributing their income currently.

B. Comparison of committee amendments with House provision

With the exception of the two relatively minor amendments described below, your committee's bill retains the provision of the House bill without change.

The attention of your committee was called to the fact that under the House bill where there was a foreign trust to which both U.S. persons and foreign persons contributed money or property, a U.S. beneficiary receiving a distribution from such a trust would be taxable on the entire amount of the accumulated income. It is believed that the purpose of the provision was to subject to taxation distributions from foreign trusts only to the extent that the corpus was contributed by U.S. persons. Accordingly, your committee's bill amends the definition of the term "foreign trusts created by a U.S. person", so that it will apply only to the extent that money or property is transferred (directly or indirectly) by a U.S. person, or under the will of a decedent who was a U.S. citizen or resident at the time of his death. Hence, where a foreign trust is created to which U.S. persons and foreign persons both contributed money or property, the U.S. beneficiary will be taxed only to the extent the distribution is attributable to money or property (including earnings thereon) contributed by the U.S. person.

Under the House bill, the new provisions would apply with respect to distributions made in taxable years of trusts beginning after the date of enactment of this bill. In the case of a calendar year foreign

trust, the new rules would not be applicable to distributions made prior to the end of the current year, whereas they may apply sooner to foreign trusts operating on a fiscal year basis. In order to equalize the tax consequences with respect to all foreign trusts, your committee amended the effective date provision to make the new rules applicable with respect to all distributions made after the date of enactment of the bill.

C. General explanation of provision

The bill, as amended by your committee, provides for taxing American beneficiaries on distributions received from foreign trusts which are created by U.S. grantors, settlors, or transferors in substantially the same manner as if the income had been distributed to the beneficiary currently as earned, instead of being accumulated in the trust. The bill, in effect, eliminates the 5-year limitation and all the exceptions applicable to domestic trusts, and provides an unlimited throwback rule with respect to distributions from foreign trusts. However, only distributions of income accumulated after the effective date of the 1954 Code will be subject to the new provisions.

The new provision applies to foreign trusts to the extent money or property has been transferred, directly or indirectly, by U.S. persons or under the will of a decedent who was a U.S. citizen or resident. A foreign trust for this purpose is one the income of which from sources without the United States is not includible in gross income for U.S. tax purposes. The term "U.S. persons" as used here includes U.S. citizens or residents, domestic partnerships and corporations, and estates and trusts.

In the case of these foreign trusts, all of their accumulated income, other than income distributable currently, upon distribution to a U.S. citizen or resident is to be taxed to him. The amounts distributed to the U.S. beneficiary are treated as if they had been distributed in the preceding years in which income was accumulated, but are includible in income of the beneficiary for the current year. However, under the bill the tax on such amounts may be computed, at the election of the beneficiary in either of two ways. One method, referred to here as the "exact" method, is substantially the same as the method provided under present law in the case of distributions subject to the "5-year throwback rule." The other is a "shortcut" method which the beneficiary may elect if he does not desire to go through the more extensive computations required by the exact method.

Under the exact method of computation, the tax on the amounts distributed cannot exceed the aggregate of the taxes that would have been payable if the distributions had actually been made in the prior years. This method requires complete trust and beneficiary records for all past years, so that the distributable net income of the trust can be determined for each year, as well as the years in which trust income was accumulated. The beneficiary's own tax then is recomputed for these years, including in his income the appropriate amount of trust income for each of the years (including his share of any tax paid by the trust). Against the additional tax computed in this manner the beneficiary is allowed a credit for his share of the taxes paid by the trust, including a foreign tax credit for income taxes paid foreign countries. Any remaining tax then is due and payable as a

part of the tax for the current year in which the distribution was received.

The so-called short-cut method in effect averages the tax attributable to the distribution over a number of years, equal to the number in which the income was earned by the trust. This is accomplished by including, for purposes of tentative computations, a fraction of the income received from the trust in the beneficiary's income for the current year and each of the 2 immediately prior years.[1] The fraction of the income included in each of these years is the same as the number of years in which the income was accumulated by the trust. Thus if the accumulated income is attributable to 10 different years (although the trust may have been in existence over longer than a 10-year period, however), then one-tenth of the amount distributed would be included in the income of the current year and one-tenth in each of the 2 prior years. The additional tax is then computed with respect to these 3 years and the average additional tax for the 3 years determined. This average is then multiplied by the number of years to which the trust income relates, namely 10 in the example used here. The tax so computed may be offset by a foreign tax credit for any foreign taxes paid by the trust and any remaining tax liability is due and payable in the same year as the tax on the beneficiary's other income in the year of the distribution.

The bill provides certain exceptions from the two computation methods outlined above. First, if the shortcut method is used and the number of trust years to which the income relates is less than 3, then the average is determined on the basis of any smaller number of years to which the distribution actually relates. Second, if the beneficiary was not yet born, with respect to a year to which part of the trust income which is distributed relates, the so-called exact method of computation is not to be used. Similarly, where the beneficiary was not alive for the full 3-year period in which the shortcut averaging device is applied, then this averaging device is to be computed on the basis of the shorter period in which the beneficiary was in existence. Third, the bill specifies how prior distributions from foreign trusts to the beneficiary are to be treated in making these computations. Where a taxpayer with respect to an earlier distribution has used the shortcut method and subsequently uses the exact method for another distribution, for purposes of this exact computation any income received from the trust in the earlier distribution must be included in his income for any year to which the second distribution relates. However, where in the current distribution the taxpayer is using the so-called shortcut method, he is not required to take into account prior distributions from a foreign trust, whether the exact or shortcut method of taxation was used in the prior computations.

As under present law, the methods of tax computation outlined above are substitutes for including and taxing the entire amount of the distribution in the year actually received. To take advantage of either method the beneficiary at the time of making the election must supply such information with respect to the operation and accounts of the trust for each of the years in which an amount is considered distributed as the Secretary or his delegate may by regulation pre-

[1] The 2 prior years are included for this purpose only to prevent the current year, in whicht here may be special circumstances, from having too great an influence on the averaging device used.

scribe. This information is necessary in order to give assurance that the computation is made correctly.

So that the Internal Revenue Service will be aware of the existence of foreign trusts created by American grantors, settlors or transferors, the bill provides that the grantor of an inter vivos trust or the fiduciary of an estate in the case of a testamentary trust, or the transferor is to make a return within 90 days after the creation of the foreign trust or the transfer of money or property to it by an American person, setting forth such information with respect to the foreign trust as the Secretary or his delegate prescribes by regulation as necessary to carry out the provisions of the income tax laws. Failure to supply the information, unless it can be shown that this failure is due to reasonable cause, is to result in a civil penalty (in addition to any criminal penalty presently provided by law) equal to 5 percent of the amount transferred to the trust but not to exceed $1,000. A similar penalty applies with respect to a return which does not show the information required, even though the return itself is filed.

Generally, these provisions relating to foreign trusts are to apply to distributions made after the date of enactment of this bill. The provisions relating to returns with respect to the creation of, or transfers to, a foreign trust, the civil penalties relating to these returns, and the definitions of U.S. persons and foreign estates and trusts are to be effective on the date of enactment of the bill.

VIII. MUTUAL FIRE AND CASUALTY INSURANCE COMPANIES, ETC.

(Sec. 8 of the bill and secs. 821–826, 831, and 832 of code)

A. *Reasons for provision*

Stock fire and casualty insurance companies have long been taxed at ordinary corporate income tax rates on both investment income and underwriting income. Mutual fire and casualty insurance companies, on the other hand, since 1941 have paid tax under special formulas which do not take into account their underwriting income or loss. Generally, these mutual companies presently are taxed under whichever of two formulas results in the higher tax. Under one formula, they are taxed at ordinary corporate income tax rates on investment income only. Under the other, they pay a tax of 1 percent on their gross investment income plus their premium income after policyholder dividends. Reciprocal underwriters and interinsurers are taxed only on their investment income and they have a vanishing $50,000 exemption. Mutual companies with total receipts of not more than $75,000 are tax exempt.

The President recommended that stock and mutual fire and casualty insurance companies be taxed on the same basis. He proposed that mutual companies pay tax on their underwriting profits, as well as on their investment income, substantially in the same manner as stock companies.

This bill to a considerable degree achieves the result sought by the President. Under it, mutual fire and casualty insurance companies are taxed under a modified total income formula. The modifications are required because of the special circumstances of the mutual companies.

While a stock insurance company can pay extraordinary losses not only out of its accumulated profits but out of its paid-in capital' a mutual insurance company can pay extraordinary losses only out of retained underwriting income. As a result, a mutual ordinarily retains a portion of its underwriting income each year for this purpose; the remainder is paid to its policyholders as policy dividends. This accumulated underwriting income constitutes its reserve out of which insurance losses can be paid, and the existence of such reserves is an important protection to the mutual policyholders.

Under the law up to this time, no income taxes have been paid on this retained underwriting income, except (since 1941) to the extent the excess of the alternative 1-percent tax over the tax on investment income in effect taxed part (all, or more than all) of the underwriting income. Similarly, underwriting losses may not reduce the tax on investment income. Under the President's proposal, underwriting gains would have been fully taxed as realized. Under the provisions of this bill, however, these mutual fire and casualty companies will be permitted to set aside a portion of each year's underwriting gain in a special account for protection against losses. This amount will be available to meet certain losses for 5 years, after which most of any remaining portion will be included in taxable income of the sixth year. A small portion, however, will still be retained in the special account to take care of extraordinary losses. Eventually, these companies will pay tax on their total income, but the tax deferral formula of the bill gives recognition to the mutuals' lack of access to the capital market for funds with which to pay losses. Under the bill underwriting losses, other than losses created by the special protection against loss deduction, will reduce the tax on investment income.

Under the bill mutual companies which have substantial underwriting gains will pay larger taxes than under present law. However, the full impact of taxing their underwriting income will be delayed until 1968. Thus, for a 5-year period only a portion of underwriting income of the mutual fire and casualty industry will be exposed to the Federal income tax. Thereafter, most of the amounts in the account which are not used for the payment of losses within 5 years will be taxed, but this will be offset—or more than offset if the company is growing and its underwriting income is increasing—by the portion of the income of the sixth and subsequent years which is set aside in the protection against loss account.

On the other hand, mutual fire and casualty companies having underwriting losses will, for the first time, be permitted to deduct these losses in full. For such companies the tax under the bill will be less than under present law which taxes the investment income of a mutual company at full corporate rates even though there is an underwriting loss. On the other hand, a stock company is taxed only on the net amount after deducting an underwriting loss against investment income. This inequality of treatment should not continue. Under this bill an underwriting loss would, depending on the circumstances, be offset against either investment income or the protection against loss account, or both, and any loss not so absorbed would be carried back (though not to a year before 1963) or carried forward, as in the case of corporations generally.

B. Comparison of committee amendments with House provision

Your committee has approved the basic provisions of the House bill taxing mutual fire and casualty insurance companies on their underwriting profits. Under both the House bill and your committee's bill, a portion of underwriting income is permitted to be set aside for a 5-year period for the purpose of offsetting insurance losses. The remainder will be currently taxed.

However, your committee modified the House bill to eliminate a discrimination in the manner in which losses are to be charged by mutual companies. Under the House bill, a mutual fire or casualty insurance company operating on a "deviated premium" basis (under which, in effect, policyholder dividends are deducted in advance of the policy period and only the net amount is charged for a policy) was permitted to charge all its underwriting losses (other than those created by the protection against loss deduction) directly against investment income. A dividend-paying mutual, on the other hand, even though its net premium at the end of the year (after payment of policyholder dividend) was identical to that charged by the deviating company, would have been compelled to reduce the underwriting loss chargeable to investment income by the amount of the policyholder dividends.

The effect of this discrimination was that in loss years the deviating company could charge larger amounts of underwriting loss to investment income and retain its protection against loss account, while a dividend-paying company was permitted to charge lesser amounts of underwriting loss to investment income and was required to deplete its protection against loss account more rapidly by charging to it not only losses created by the protection against loss deduction but also losses created by the payment of policyholder dividends. Since these dividends are viewed solely as price adjustments in the cost of insurance, your committee feels the tax consequences should be the same regardless of whether the price of the policy is adjusted at the time the policy is sold (by means of a deviated premium) or at the end of the policy period (by means of a policy dividend).

To eliminate this discrimination and to place mutual companies on a basis more comparable to stock companies (which are permitted under existing law to charge underwriting losses created by dividends directly against investment income), your committee's bill permits underwriting losses arising from the payment of policy dividends (price adjustments) to be charged first to investment income with any remaining unused losses then being charged to the protection against loss account.

Some mutual insurance companies specialize in insurance against limited risks such as windstorm, hail, or flood, in relatively small geographical areas. Because their operations cover a small area, few storms or floods may occur in some years and the company will then have relatively large underwriting gains; in other years, storms may cause heavy damage in the area of operations and the company will have relatively large underwriting losses. To compensate for this uneven experience both the House and your committee's bills permit these concentrated risk companies to defer, in the protection against loss account, a greater proportion of underwriting income than is permitted for ordinary companies. This is to protect them against unusually large losses if, and when, such losses occur.

Your committee has amended the House provision relating to the concentrated risk companies in two respects. Both are concerned with the qualification of companies for the additional protection against loss deduction. Under the House bill, a concentrated risk company was one which derived more than 50 percent of its premium income from insuring in one State against losses arising from wind, hail, floods, etc. Your committee believes that a company which has 40 percent of its premium income from such risks assumed in a limited area should also qualify as a concentrated risk company. Accordingly, the percentage test has been reduced to 40 percent. In addition, in recognition that storms and similar hazards are not restricted by State boundaries, your committee has added an alternative area test to the one-State test of the House bill. Under this alternative test, if more than 40 percent of its premium income is from the specified risks arising within a circle having a 200-mile radius (a 400-mile diameter), the company will qualify.

Under existing law, very small mutual companies, that is, companies whose total receipts from all sources (including premiums) do not exceed $75,000, are exempt from tax. The House bill did not alter this exemption. Your committee, however, has concluded that the $75,000 limitation on the exemption, which was provided in 1942, is totally inadequate by today's standards. To bring this exemption into line with current conditions, your committee's bill increases the limitation on the small company exemption to $150,000.

The House bill provided a special tax treatment for mutual companies with total receipts between $75,000 and $300,000. Companies in this category would have been treated much as they are under existing law; i.e., these companies would pay tax on their investment income only (however, the alternative 1-percent tax of present law would no longer apply).

Your committee has approved this provision of the House bill, but has amended the limitations. First, the minimum limit has been increased to $150,000 to coincide with the new limitation on exemption for the very small companies. The maximum limitation has been increased to $600,000 (from $300,000 in the House bill). This treatment is justified because these small companies often are of the assessment type and are not required to compute and report their underwriting income on approved forms for State insurance commission purposes. The bill makes it unnecessary for them to compute their underwriting income in the future. Moreover, this amendment will enable these small, often new, companies to maintain sufficient reserves so that they can obtain reinsurance at reasonable rates. Small companies with total receipts between $600,000 and $1,200,000 ($300,000 and $900,000 in the House bill) will be taxed both on their investment income and on their underwriting income. However, to provide for a gradual transition to the new tax on their underwriting income, like the House bill your committee's bill provides a special deduction of $6,000 which decreases as total receipts of the company increase above $600,000. This means that at $1,200,000 there is no special deduction.

Reciprocal underwriters and interinsurers differ from ordinary mutual insurance companies in that their business is conducted by two entities rather than one. An ordinary mutual insurance company receives all of the premium income from insurance and not only

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pays losses but conducts directly the operation and management of the insurance activities. The reciprocal underwriter or interinsurer, on the other hand, pays its insurance losses, but an "attorney-in-fact" performs all, or most, of the insurance functions—writing policies, collecting premiums, settling claims, keeping records, etc.—and pays the related expenses, for a portion of the premium income of the reciprocal. Profits realized by the attorney-in-fact from conducting these insurance operations are taxed as ordinary income. However, if that income were earned by a mutual insurance company which performed these operations itself, under existing law it would constitute underwriting income and would not be taxed. Moreover, under present law reciprocal underwriters and interinsurers are not taxed in the same way as ordinary mutuals since they are not subject to the alternative 1-percent tax and have a special exemption. The House bill taxes reciprocal underwriters and interinsurers under the same rules that apply to ordinary mutuals; but in recognition of their unique form of operation it permits them in effect to combine the underwriting income of the attorney-in-fact with their own for the purpose of offsetting certain losses. This provision has been approved with a change which permits the reciprocal to use the combined underwriting income as the basis for setting aside 25 percent of underwriting income in the protection against loss account; thus, in effect, increasing the amount of its own underwriting income upon which tax may be deferred.

Under present law, factory mutual insurance companies are taxed under the same formulas as other mutuals; that is, they pay tax on investment income only (with no deduction for underwriting losses) or under the alternative 1-percent formula. However, because of the very large premium deposits required of their policyholders (typically up to 10 times the amount of an ordinary premium) the investment income of such companies is very large. As a result in practice they never become subject to the alternative 1-percent tax. As in the case of other mutuals, these companies are not permitted to deduct their underwriting losses. This has been a handicap to these companies in years in which they have losses, because the industrial risks which they insure generally are quite large. The House provision, approved without change by your committee, taxes factory mutual companies as if they were stock companies, thus permitting them to deduct underwriting losses when they occur. However, since a large portion of each premium is in effect a deposit (which may be returned to the policyholder), in computing their underwriting profits these companies are to be permitted to determine their premium income on the basis of their schedules of absorbed premium deposits. The amount so determined will be increased by 2 percent for income tax purposes to offset the advantage of the temporary use of deposits which would ordinarily be viewed as premiums received.

Your committee added two new provisions to the House bill. One of these deals with mutual flood insurance companies. It was brought to the committee's attention that some mutual flood insurance companies (including reciprocal exchanges) operate on a premium deposit system quite similar to that employed by factory mutual fire insurance companies. Because of the similarity of their method of operation, your committee has concluded that these companies should be taxed in the same manner as factory mutual fire insurance com-

panies. Accordingly, your committee has amended the House bill to provide that mutual flood insurance companies are to be taxed under the rules also made applicable by this bill to factory mutual fire insurance companies. Under these rules these flood insurance companies are to determine their underwriting income on the basis of their schedule of premium absorptions. Of course, these companies will also be required to increase the amount of their absorbed premiums by 2 percent of the amount actually absorbed.

The second amendment provides that a mutual company which experienced underwriting losses in each of 5 out of the 6 years immediately preceding 1963 is to be provided a special 5-year carryover of the excess of underwriting losses over underwriting gains during the 6-year period. This exception to the general rule of the bill that underwriting losses may not be carried over from a year prior to 1963 will prevent a company with a long history of unusual loss experience from being penalized in years when it is retaining unusual amounts of underwriting income to restore its reserves to their normal level, particularly when the underwriting losses were not permitted to be taken into account in computing taxable income in the 6-year period. In cases cited to the committee, to which this provision applies, some mutual insurance companies actually paid taxes for the 6-year period in excess of total income for that period.

C. General explanation of provision

Under present law the tax on a mutual fire and casualty insurance company is, in general, the greater of (1) a tax at the ordinary corporation rates on the company's net income from investments, or (2) a tax of 1 percent of its gross income from both investments and premiums less dividends to policyholders. Under the provisions of this bill the 1-percent alternative tax is eliminated, and the tax is computed at the ordinary corporation rates on the company's total income (investment income and underwriting income) less amounts temporarily set aside in a protection against loss account. Underwriting income of these insurance companies is the excess of earned premiums over insurance losses and expenses incurred and dividends paid to policyholders.

There are special provisions for companies with concentrated risks, for small companies, and for reciprocals or interinsurers. The bill also removes the factory mutuals from the treatment accorded mutual casualty companies generally, and treats them as if they were stock companies, with special provisions for determining what portion of their premium deposits is to be viewed as earned premiums.

1. *Ordinary mutual fire and casualty insurance companies.*—Under the bill taxable income of mutual insurance companies will consist of taxable investment income, statutory underwriting income, and certain amounts previously set aside for protection against losses. Statutory underwriting income, as used in the bill, is underwriting income after a special deduction for protection against losses of an amount equal to 1 percent of insurance losses incurred during the year and 25 percent of the ordinary underwriting income.

An amount equal to the special deduction is to be set aside for 5 years in a "protection against loss" account where it can be used only for offsetting losses. After the fifth year, if the amount credited

to the protection against loss account has not been absorbed by losses, the portion attributable to the 1 percent of losses and one-half of the portion attributable to the 25 percent of underwriting income will be withdrawn from the account and included in taxable income. The other one-half of the amount representing the 25 percent of underwriting income is retained in the account for a longer period as a cushion against extraordinary losses.

The bill limits the amount which may be accumulated in this account, however. The amount in this account may not be increased above an amount which at the end of any year is more than 10 percent of the earned premiums less dividends to policyholders for that year. If a greater amount were already in the account at the beginning of the year, the account would not be reduced (because of the ceiling) below this amount.

If in any year there is a loss from underwriting instead of a gain, the part of the loss resulting from the payment of insurance claims and expenses and policy dividends would be offset directly against taxable investment income. Any amount not so offset and other losses (those resulting from the special protection against loss deduction) would be charged against the protection against loss account on a first-in, first-out basis. Losses charged against the account would be applied proportionately to amounts representing the 1 percent of losses incurred and the 25 percent of underwriting income.

If in any year there is an extraordinary underwriting loss—more than the investment income for that year and the entire amount in the protection against loss account—the excess will be treated much like an ordinary net operating loss, to be carried back against the taxable income of the 3 preceding years or carried forward (first against amounts added to the protection against loss account and then against otherwise taxable income) to the succeeding 5 years, as in the case with any corporation.

In computing their taxable income, mutual companies are to be allowed an unlimited deduction for dividends paid to policyholders, just as stock companies may take unlimited deductions for their policy dividends.

Under present law, mutual insurance companies which are not subject to the 1-percent alternative tax are allowed a special exemption of $3,000, with the tax on taxable incomes between $3,000 and $6,000 gradually increasing until the exemption completely vanishes when taxable income reaches $6,000. The bill increases this special exemption (applicable to the new total of investment and underwriting income) to $6,000 in the case of mutual companies taxable under the general rules of the bill. There also is a gradually increasing tax on taxable incomes between $6,000 and $12,000, so the exemption vanishes when taxable income reaches $12,000.

2. Example.—The computation of taxable income, statutory underwriting gain and the protection against loss account for a 6-year period with successive underwriting gains, may be illustrated as follows, assuming the simplified facts as shown in the following table:

Year	Taxable investment income	Underwriting income	Insurance losses incurred	Additions to protection against loss account
1963	$10	$12	$700	$7+$3 ($10)
1964	11	16	800	8+ 4 (12)
1965	12	12	600	6+ 3 (9)
1966	13	20	600	6+ 5 (11)
1967	14	24	900	9+ 6 (15)
1968	15	20	1,000	10+ 5 (15)

For 1963 the statutory underwriting income would be $2, the underwriting income of $12 minus the 1 percent of incurred losses ($7) and the 25 percent of the underwriting income ($3) credited to the protection against loss account. The taxable income would be $12, the sum of the taxable investment income and the statutory underwriting income. For 1964 the statutory underwriting income would be $4 and the taxable income $15; for 1965 corresponding figures would be $3 and $15; for 1966, $9 and $22; and for 1967, $9 and $23.

For 1968 the statutory underwriting income would be $5 ($20 minus $10 minus $5), but there would be included in taxable income an amount equal to the first item added to the protection against loss account in 1963 ($7), and half of the second item ($1.5), so that for 1968 the taxable income would be $28.5, the sum of the taxable investment income ($15), the statutory underwriting income ($5), and the $8.5 withdrawn from the protection against loss account.

At the end of 1968, therefore, the total amount in the protection against loss account would be $63.5—amounts totaling $62 added for 1964 and the 4 following years which will be available to offset losses occurring during the next 5 years, and a residual $1.5 from 1963 to offset any loss which exceeded the entire amount in the account other than that.

If, in the preceding example, for 1966 there had been an underwriting loss of $30 (excluding the protection against loss deduction), and insurance losses incurred had still been $600 the deduction added to the protection against loss account would thus have been 1 percent of $600 or $6 and the statutory underwriting loss would be $36. In that case the portion of the loss not resulting from the protection against loss deduction ($30) would be offset against the taxable investment income of $13, the taxable income for 1966 thus being zero. The remaining portion of the loss ($23) would be charged against the protection against loss account, the $10 added to that account in 1963 and the $12 added in 1964 being eliminated, and of the 1965 addition there would remain $5.33 and $2.67. In that case there would be nothing from the protection against loss account to be included in taxable income for 1968 or 1969.

Under the bill, as passed by the House and approved by your committee, the rules applicable to mutual fire and casualty companies accruing market discount on bonds are changed. Under present law all mutual fire and casualty companies (and life insurance companies) are required to accrue each year a ratable portion of market discount on bonds and pay tax thereon at ordinary income tax rates (Rev. Rul. 60–210; 1960–1 CB 38). Stock fire and casualty insurance companies, on the other hand, are not required to accrue such discount but when the bond is sold or redeemed they are required to pay tax on the

amount of gain resulting from market discount at capital gains rates (if the bond is held for more than 6 months). Since under the general rule of the bill the starting point in computing "mutual insurance company taxable income" is the gross income computed as if the taxpayer were a stock company, the effect is to treat market discount on bonds for mutual companies, other than the small companies taxable on investment income only) as it is treated by the stock companies.

3. Casualty companies with concentrated windstorm, etc., risks.—As stated above, most mutual insurance companies will report and pay a tax currently on the underwriting income remaining after transferring to the protection against loss account 25 percent of underwriting income plus 1 percent of incurred losses. With respect to certain insurance companies whose risks are primarily from losses from windstorm, hail, flood, earthquake, or similar natural hazard, and are concentrated in one State, or within 200 miles of any point selected annually by the taxpayer, the bill permits deferral of more than 25 percent of underwriting income. The percentage of underwriting income which can be credited to the account in such a case is determined by dividing the premiums earned on insurance contracts covering the risks in the designated area by total premiums earned by the insurance company. If this does not exceed 40 percent, the regular rule is used. If it does, the normal deduction of 25 percent of underwriting income is increased by the excess percentage points over 40 percent. Thus, under this rule, a company which has 80 percent of its windstorm, etc., risks insured in one State (or in a circle having a 400-mile diameter) would be permitted to transfer 65 percent (the regular 25 percent plus 40 percent) of its underwriting income to the protection against loss account. (However, concentration of risks will not serve to permit a larger percentage of incurred losses to be credited to the protection against loss account.)

The overall limitation on the protection against loss account of 10 percent of premiums less policy dividends for the year is not to apply to the amount of underwriting income in excess of 25 percent which these concentrated risk companies add to their protection against loss account. If it did apply it would defeat the objective of allowing a greater portion of underwriting income to be set aside. In applying the ceiling the concentrated risk company is to be treated as if it had transferred only 25 percent of its underwriting income to the account.

4. Small companies.—Under the bill, small mutual fire and casualty insurance companies (those whose total receipts—gross investment income, excluding capital gains, plus premiums—exceed $150,000 but do not exceed $600,000) are not taxed on underwriting income. As under present law, these companies will continue to pay tax on investment income only (with no deduction for underwriting losses) but the alternative 1-percent tax will no longer apply. The special exemption of $3,000, with the "notch" rates applying to taxable incomes between $3,000 and $6,000, also will continue in effect.

Despite the treatment for these small companies described above, the bill permits them to elect to be taxed on total income, including underwriting income, in the same manner as other mutual companies, and such an electing company will similarly be allowed to deduct underwriting losses. Presumably the existence, or expectation, of underwriting losses would be the primary reason for making this election. The election, once made, cannot be changed without the consent

of the Treasury Department. On the other hand, a small mutual company which becomes taxable under the general rules because its gross investment income plus premiums exceed $600,000 in a taxable year, again will be taxed as a small company if its income falls below this level, if one condition is met. If, while it was taxed under the regular formula it was required to credit a portion of its underwriting income to the protection against loss account, this amount must be taken into income and a tax paid on it before the small company treatment will again apply. To provide consistent tax treatment for these small companies, the bill does not permit loss carrybacks or carryovers to be carried to, from, or over a year in which the company was taxable as a small company.

In the case of mutual fire or casualty insurance companies whose total receipts are between $600,000 and $1,200,000, the bill provides a special vanishing deduction which is to apply to underwriting income only. For a company whose total receipts are $600,000, the special deduction will be $6,000. As total receipts increase, the $6,000 deduction decreases and finally vanishes when total receipts of the company equal $1,200,000.

5. *Reciprocal underwriters and interinsurers.*—Under the bill, reciprocal underwriters and interinsurers are in general taxed in the same way as ordinary mutuals, with two important exceptions.

First, reciprocal underwriters and interinsurers may elect to take into account the income of the attorney-in-fact which is attributable to the insurance business of the reciprocal. It accomplishes this by not deducting that part of the fee paid to the attorney-in-fact which is equivalent to the attorney-in-fact's profit from the insurance operation. This election may be made, however, only if the attorney-in-fact is a corporation which keeps its records on the same basis as the reciprocal and certain other requirements are met.

An election by a reciprocal is never to reduce income taxes of the attorney-in-fact. The attorney-in-fact will continue to determine its tax just as it does under present law except that it must identify income and expense items attributable to the insurance business of the reciprocal.

An electing reciprocal will compute its tax liability on the combined income, under your committee's amendments, by applying the formula of this bill to the combined underwriting income. As an offset to the increased tax due to the inclusion of the income of the attorney-in-fact, the reciprocal may take tax credit for the tax paid by the attorney-in-fact with respect to its income from insurance operations. (Under certain circumstances this may result in a refund to the reciprocal.)

If the combined underwriting account of the reciprocal and its attorney-in-fact shows a loss the ordinary rules of the bill for charging it are to apply. Thus, the loss would be charged first to investment income if it is from the payment of claims, policy dividends or expenses, or to the protection against loss account of the reciprocal if it is a loss created by the special loss protection deduction.

The inclusion of the income of the attorney-in-fact in the income of the reciprocal permits the reciprocal to set aside a larger portion of income in the protection against loss account than it otherwise could, since 25 percent of the combined income is thus set aside. Your committee believes this amendment is necessary to give policy-

holders of a reciprocal company much the same protection as that given to the policyholders of an ordinary mutual company. However, a reciprocal, under your committee's amendment, must after 5 years restore to income all of the amount added to the protection against loss account which was attributable to the income of the attorney-in-fact which has not in the interval been absorbed by losses.

The second special feature of the bill relating to reciprocal underwriters or interinsurers permits them to deduct savings credited to individual subscribers' accounts (in the same manner as policyholder dividends paid in cash) if the company is obligated to pay those amounts promptly to the subscriber if he terminates his contract. This is provided because the "pure," or "classical," reciprocal or interinsurer typically credits the account of each policyholder with savings attributable to his contract and because the policyholder has a legal right to receive the amount so credited if he withdraws from the exchange. Because amounts credited to the account of an individual subscriber represent reductions to him in the cost of insurance, the bill provides that for income tax purposes the subscriber must reflect this reduction when the credit is made.

This deduction for credited savings, as stated above, is to be available only in case of so-called "pure" or "classical" reciprocals or interinsurers where the credits, as a matter of actual practice, are paid to policyholder subscribers who terminate their contracts. An ordinary reciprocal which may nominally meet the requirement of the statute would not be entitled to this deduction where savings credited to subscribers are not in fact returned to them when they terminate their policies.

6. *Factory mutual insurance companies.*—The bill amends the law with respect to factory mutual insurance companies in two important respects. First, commencing in 1963, these companies will be treated for tax purposes as if they were stock companies. This means that they will report their underwriting income in full in the year earned, and their underwriting losses after 1962 will be deductible in full.

Secondly, the method of computing premium income of factory mutuals is modified to conform more closely to the actual operation of these companies. This is accomplished by permitting them to determine their premium income on the basis of their schedule of absorbed premium deposits. The amount thus determined is then to be increased under the bill by 2 percent of absorbed premiums for income tax purposes. For example, a factory mutual might require a premium deposit of $1,000 and its experience indicates it will absorb 12 percent of the premium deposit each year during the term of the policy. Under existing law, in the case of a 3-year policy, the factory mutual would realize earned premiums of $333.33 each year (one-third of the premium deposit) and would deduct returns to policyholders as if they were dividends. Actually, however, the factory mutual absorbs only 12 percent of the premium deposit, or $120 each year. Under the bill, this factory mutual will report for income tax purposes $122.40 ($120 plus 2 percent of $120). This bill also provides for an adjustment in the unearned premium account of the factory mutual for returns of unabsorbed premium deposits to policyholders upon termination of their policies. This return of unabsorbed premium deposit is viewed as analogous to a dividend or a payment similar to a dividend.

7. *Mutual marine insurance companies.*—Mutual marine insurance companies have been taxed as stock insurance companies for many years and your committee's bill continues this treatment for them. However, a question has arisen as to whether such a company, if previously taxed as a mutual marine company, should continue to be so taxed. Your committee believes that under existing law a taxpayer which has always filed its returns as a mutual marine company should be treated as such for all years without regard to whether marine premiums still constitute its predominant source of premium income. In order to clarify the law, and foreclose the possibility that a mutual company may be taxed under different sections in different years, in lieu of a definition, your committee's bill provides that any mutual marine insurance company which was taxed as a stock company for a period of at least 5 years may elect to continue to be so taxed. The phrase "whether or not marine insurance is its predominant source of premium income" is intended to make clear that a company which has been taxed as a mutual marine company, and which has always filed its returns as a mutual marine company, may be treated as a stock company for all such years, even though marine insurance is no longer its predominant source of premium income.

8. *Special transitional loss deduction.*—Your committee has added a new provision to the House bill under which mutual insurance companies which have experienced a long and unusual period of underwriting losses will be permitted to take those losses into account in determining their taxable income. Companies qualifying for this treatment are those who have incurred underwriting losses in at least 5 out of the 6 taxable years preceding 1963. Companies which qualify for this treatment may deduct the excess of their underwriting losses over underwriting gains for the 6-year period in the years 1963 through 1967. This 5-year period is the same as the 5-year carryforward provision of present law which applies in the case of net operating losses. Your committee felt that this treatment is justified because companies with long unfortunate loss experience must of necessity retain additional amounts of underwriting income to rebuild their reserves to a safe level. In the absence of this provision, these companies would be subjected to tax on an unusually high proportion of underwriting income.

9. *Exemption for small mutual insurance companies.*—Your committee also has added a new provision to the House bill which increases the limitation on tax exemption for small mutual insurance companies from $75,000 to $150,000. Increasing this limitation will provide complete tax exemption for approximately 160 additional small mutual insurance companies, many of which are of the pure assessment type.

10. *Mutual flood insurance companies.*—Another provision added to the House bill by your committee requires mutual flood insurance companies to be taxed under the stock formula in the same manner as mutual fire insurance companies issuing policies for which the premium deposits are the same regardless of the length of the term for which the policies are issued if the unabsorbed portion of the premium is returned to the insured upon termination of the policy. This same rule (as explained in par. 6, above) applies also to factory mutual insurance companies.

11. *Effective dates.*—The amendments made by this section are to apply with respect to taxable years beginning after December 31, 1962, except that the amendment relating to mutual marine insurance companies is to apply to taxable years beginning after December 31, 1961.

IX. DOMESTIC CORPORATIONS RECEIVING DIVIDENDS FROM FOREIGN CORPORATIONS

(Sec. 9 of the bill and secs. 902 and 78 of code)

A. Reasons for provision

The Secretary of the Treasury in his appearance before your committee stated that foreign income received by domestic corporations in the form of dividends—

> is, in effect, deducted from taxable profits in computing the U.S. tax, but a good share of it is also allowed as a credit against the U.S. tax liability.

He termed this an unjustified tax advantage and recommended that, as provided in the House bill, it be eliminated.

The problem arises when the foreign tax rate is below the U.S. tax rate and results from the fact that the amount paid in foreign taxes not only is allowed in part as a credit in computing the U.S. tax of the corporation receiving the dividend, but also is in effect allowed as a deduction (since the dividends can only be paid out of income remaining after payment of the foreign tax).

The problem can be illustrated by assuming that a foreign government imposes a 30-percent tax with respect to $1,000 of income of a corporation. This would leave $700 of the $1,000 out of which a dividend could be paid to a U.S. parent corporation. If the applicable U.S. tax rate is 52 percent, the American tax on this $700 before the allowance of any foreign tax credit would be $364. On the other hand, if the $1,000 of income had been earned by a branch of the U.S. corporation, the entire $1,000 would be subject to U.S. tax before allowance of any foreign tax credit. Thus, in this case the tentative U.S. tax would be $520, or $156 more than in the case of the foreign subsidiary.

In the case of the foreign subsidiary, the foreign tax allowed as a credit is limited to the same proportion of the tax which the income included in the American tax base is of the total income.[1] Thus, the allowable credit in the case of the foreign subsidiary is limited to seven-tenths of the $300 or $210. As a result the final U.S. tax on the dividend is $154 ($364 minus $210). This U.S. tax of $154, plus the foreign tax of $300, results in a total tax of $454, which is $66 less than the full $520 tax which would be paid by a domestic corporation operating in this country, or operating abroad through a branch.[2] This example is summarized in table 4 below.

[1] This is the result of the decision in *American Chicle Company* v. *U.S.*, 316 U.S. 450 (1942).
[2] As indicated above, the U.S. tax before credit in the case of the branch would be $520. After allowing the $300 foreign tax credit in this case, the final U.S. tax would be $220 which, with the $300 of foreign tax, means a total tax of $520.

TABLE 4.—*The computation of corporate taxes on foreign income*

	Existing law	Proposed law
	Dollars	*Dollars*
Profits of subsidiary	100.0	100
Foreign tax (assumed rate: 30 percent)	30.0	30
Dividend to U.S. parent	70.0	70
"Gross-up" of dividend		30
Tentative U.S. tax at 52 percent	36.4	52
Credit for foreign tax paid by subsidiary	21.0	30
Net U.S. tax	15.4	22
Combined foreign and U.S. tax	45.4	52

The size of this tax differential which exists in the case of dividends from foreign subsidiaries at the present time varies with the size of the foreign tax rate. As shown in table 5, the tax differential disappears either when the foreign tax rate equals or exceeds the U.S. tax or when there is no foreign tax imposed at all. The maximum tax differential, given a 52-percent U.S. tax rate, occurs when the foreign tax rate is half that, or 26 percent. The differential at this point is 6.7 percentage points.[3] Where dividends are received by a domestic corporation from its foreign subsidiary, which in turn has received its income from another foreign subsidiary, the maximum tax differential (given the 52-percent U.S. tax rate) amounts to 11.93 percentage points.

TABLE 5.—*Rate differential enjoyed with respect to dividends from foreign subsidiaries with various selected foreign income tax rates and present 52-percent U.S. rate*

Income before tax	Foreign tax	Income available for dividend	U.S. tax before credit	Credit against U.S. tax	U.S. tax	Total tax	Rate differential enjoyed by foreign subsidiary
							Percentage points
$100	0	$100	$52.00	0	$52.00	$52.00	0
$100	$5	95	49.40	$4.75	44.65	49.65	2.35
$100	10	90	46.80	9.00	37.80	47.80	4.20
$100	20	80	41.60	16.00	25.60	45.60	6.40
$100	26	74	38.48	19.24	19.24	45.24	6.76
$100	30	70	36.40	21.00	15.40	45.40	6.60
$100	40	60	31.20	24.00	7.20	47.20	4.80
$100	50	50	26.00	25.00	1.00	51.00	1.00
$100	52	48	24.96	24.96	0	52.00	0

Two relatively minor technical corrections recommended by the administration are also included in the House bill. One of these involves the repeal of a subsection (sec. 902(d)) of one of the foreign tax credit provisions, which makes the foreign tax credit available in limited cases with respect to royalty income received from a foreign subsidiary. This royalty income is entitled to this foreign tax credit only where the domestic corporation owns all of the stock of the subsidiary. The provision granting this treatment in the case of royalty income was adopted in 1954 in order to grant relief in a case where, because of currency exchange restrictions, a corporation was prohibited from distributing its earnings. The retention of this provision would have the effect of allowing a foreign tax credit before actual dividend distributions have been made.

[3] The tax differential represents the difference between the U.S. and foreign tax rates, multiplied by the income omitted from the U.S. tax base.

Second, the House bill also follows a recommendation of the administration relating to the interrelationship of the foreign tax credit and the intercorporate dividends received deduction. The problem arises here where a foreign corporation derives 50 percent or more of its income from sources within the United States. In such a case a domestic corporation receiving dividends from it is eligible for the 85-percent intercorporate dividends received deduction with respect to the proportion of the income determined to be from sources within the United States. However, all of the remaining income is treated as income from sources without the United States for which a foreign tax credit is available, including the 15-percent amount remaining after the allowance of the intercorporate dividends received deduction which, for that purpose, was treated as income from sources within the United States. The House bill provides that this 15 percent of domestic source income, remaining after the dividend received deduction is allowed, retains its domestic source character rather than being reclassified as foreign source income for purposes of the foreign tax credit.

B. Comparison of committee amendments with House provision

Your committee agrees with the House that, as a result of including only dividend income in the tax base and at the same time allowing a foreign tax credit, the full U.S. tax is not paid on most dividend income received by domestic corporations from foreign corporations. Your committee agrees with the House that in the case of dividend income received from developed countries, there is no reason for this tax differential. Therefore, except in the case of income received from "less developed country corporations" it has provided, as does the House bill, that where a taxpayer elects the foreign tax credit he must increase, or "gross-up," his U.S. tax base by including in it the amount of foreign income paid in taxes to the extent related to the dividend received. Thus, in the example cited in part A, above, the tentative U.S. tax would be computed on the basis of $1,000, instead of $700, and then the full $300 of foreign tax would be allowed as a foreign tax credit in the same way as in the case of branches of U.S. corporations.

In the case of corporations deriving most of their income from less developed countries, however, your committee concluded that it would be inappropriate at this time to raise the effective rate of combined American-foreign tax since this would discourage new investments in such countries. Your committee believes that to discourage such investments at this time would be contrary to our national policy.

The term "less developed country corporation" for purposes of this provision has the same definition as in section 12, but here also is defined to include certain holding companies not included in the definition in section 12. In general terms, a less developed country corporation is a corporation organized under the laws of a less developed country, which is engaged in the active conduct of a trade or business, which derives 80 percent of its gross income from sources within less developed countries, and which has 80 percent in value of its assets invested in a trade or business in a less developed country and certain other assets consistent with the carrying on of this trade or business. Certain shipping and aircraft corporations also qualify. A third category of corporations which for purposes of this one provision also qualify as less developed country corporations consist of foreign hold-

ing companies (wherever incorporated) which own 10 percent or more of the stock in less developed country corporations and which receive 80 percent or more of their gross income from sources within less developed countries and have 80 percent or more in value of their assets invested in the same manner as other less developed country corporations.

Your committee has accepted the other two amendments made by the House bill without change; namely, that relating to the deletion of the provision treating royalty income in certain cases as dividends from a foreign subsidiary and that treating all income eligible for the domestic intercorporate dividends received deduction as domestic rather than foreign income for purposes of the foreign tax credit.

C. General explanation of provision

1. Provision for "gross-up" except in the case of less developed country corporations.—Your committee's amendments provide that, except in the case of less developed country corporations, if a domestic corporation elects to take a foreign tax credit (rather than a deduction for foreign taxes), it must include in its gross income an amount equal to the taxes of its subsidiary (or an amount equal to the taxes of its subsidiary's subsidiary) which it is considered, or deemed, to have paid, for purposes of the foreign tax credit provision, with respect to the dividend income received (or treated as having been received under sec. 12 below). Thus, for a domestic corporation to claim a foreign tax credit for foreign taxes paid by its subsidiary which is not a less developed country corporation, or a subsidiary of that subsidiary, it must "gross-up" its dividend income received by the amount of the foreign income, etc., taxes attributable to it.

Your committee's bill also rewrites the rules of present law which determine the portion of the foreign taxes which are treated as being attributable to dividend income received from a 10-percent-owned subsidiary which is not a less developed country corporation and from one which is a less developed country corporation.

In the case of a subsidiary which is *not* a less developed country corporation, all of the foreign income, etc., taxes can be allowed as a credit since in this case the entire earnings before tax are taken into account by the domestic corporation. In the case of dividends received from *less developed country corporations* only the portion of the foreign income, etc., taxes attributable to the accumulated earnings and profits after foreign taxes can be allowed as a credit since only these earnings and profits are taken into income by the domestic corporation. This continues the principles laid down by the Supreme Court in *American Chicle Co.* v. *United States*, 316 U.S. 450 (1942).

As under present law, if a 10-percent-owned foreign corporation owns 50 percent or more of another foreign corporation, a foreign tax credit is allowed with respect to foreign taxes paid by the second tier foreign corporation to the extent the dividends received by the domestic corporation are attributable to those paid by the second tier corporation. Under your committee's amendments dividends received by a domestic corporation are either "grossed up" or not "grossed up" in such cases on the basis of the status of the first tier foreign corporation. Thus, if the first tier foreign corporation is a less developed country corporation, the status of the second tier foreign corporation in this respect is immaterial (except insofar as

the distributions by it to the first tier corporation aid or hinder the first tier foreign corporation in qualifying as a less developed country corporation). Where there is to be no "gross-up" at the second tier level, the foreign taxes allocated to the dividend are allocated under rules consistent with the principles set forth in the court decision *American Chicle Co.* v. *United States.*

For purposes of this provision, three different categories of corporations are treated as "less developed country corporations." The first two of these are the same as the definition of a less developed country corporation for purposes of section 12 below. The third category, which essentially is a holding company for one or more less developed country corporations is an additional category that applies only for purposes of this one provision.

A less developed country corporation in the first category is a corporation organized under the laws of a less developed country, which is engaged in the active conduct of a trade or business, derives 80 percent or more of its gross income from sources within less developed countries, and has 80 percent or more of its assets (in terms of value) invested in a manner consistent with carrying on a trade or business in a less developed country. Thus, this 80 percent of its assets must consist of—

(1) Property used by it in its trade or business in less developed countries;

(2) Money and bank accounts;

(3) Stock and obligations (having a maturity of 5 years or more at time of acquisition) of less developed country corporations;

(4) An obligation of a less developed country;

(5) Investments required because of restrictions imposed by less developed countries; and

(6) Certain U.S. property, such as U.S. Government bonds, money, property purchased in the United States for export, etc., which, although having a U.S. situs, for purposes of section 12 below are excluded from the definition of "U.S. property."

The second category of corporation classified as a "less developed country corporation" consists of certain shipping or aircraft companies. These corporations must be foreign corporations 80 percent or more of the gross income of which arises from—

(1) The use (or hiring or leasing for use) in foreign commerce of aircraft or vessels registered under the laws of a less developed country;

(2) From the performance of services directly related to these aircraft or vessels;

(3) From the sale or exchange of such vessels or aircraft;

(4) Dividends and interest received from foreign corporations which are themselves less developed country corporations under the definition contained in this category and in which the corporation in question has at least a 10-percent stock interest; and

(5) Gain from the sale or exchange of stock or obligations of foreign corporations which are less developed country corporations.

In addition, to qualify as less developed country corporations, these shipping or aircraft companies must have 80 percent or more of their assets either used for the production of the income described above,

or consisting of property which although having a situs in the United States is not considered as "U.S. property" under the exceptions set forth in section 12.

The third category of corporations qualifies as less developed country corporations only for purposes of this "gross-up" provision. These corporations are foreign corporations (which may or may not be organized under the laws of a less developed country) which have at least a 10-percent stock interest in another foreign corporation which is a less developed country corporation within the meaning of the first category specified above. In addition, the foreign corporation must derive 80 percent of its gross income from sources within less developed countries and 80 percent in value of its assets must be of the type specified in category No. 1, above.

2. Dividends from U.S. sources.—The bill amends the rules used in determining whether income is from within or without the United States in the case of a foreign corporation which has received 50 percent or more of its gross income for the 3 prior years from sources within the United States. In such a case, the 85-percent intercorporate dividends received deduction is available with respect to the proportion of its income which its income derived from sources within the United States bears to its income from all sources. However, under present law all of such a corporation's income, to the extent it exceeds the 85-percent deduction allowed for intercorporate dividends received, is treated (for purposes of the foreign tax credit) as income from sources without the United States. Thus, the 15 percent for which no intercorporate dividends received deduction is allowed, although for purposes of the prior computation treated as from sources within the United States, is for this purpose treated as foreign source income. The bill corrects this technical deficiency by providing that the amount treated as foreign source income in such a case is only the remaining income in excess of this 15 percent.

3. Royalty income eligible for foreign tax credit.—The bill eliminates the provision of present law (sec. 902(d)) which treats as a distribution (and, therefore, eligible for the foreign tax credit) royalty payments received by a domestic corporation from a 100-percent owned subsidiary engaged in manufacturing, production, or mining.

4. Effective date.—The provisions referred to above are applicable to *all* dividends received by a domestic corporation after December 31, 1964. They also are to apply to *certain* dividends received by the domestic corporation in the period before January 1, 1965, but only in its taxable years beginning after December 31, 1962. (For a calendar year corporation this latter category includes certain dividends received in the calendar years 1963 and 1964.) In the case of dividends received in these years the "gross-up" and other changes made by this provision are to apply only to the extent that the dividends are treated for tax purposes as made out of the accumulated profits of the foreign corporation for taxable years beginning after December 31, 1962. Dividends received by a foreign corporation from its subsidiary before January 1, 1965, which are paid out of the subsidiary's profits from before 1963 are to be treated as paid out of the first foreign corporation's profits from before 1963 if it in turn pays the dividends to the domestic corporation before January 1, 1965.

X. SEPARATE LIMITATIONS ON FOREIGN TAX CREDIT WITH RESPECT TO CERTAIN INTEREST INCOME

(Sec. 10 of the bill and sec. 904(f) of the code)

A. Reasons for provision

The Secretary of the Treasury in his appearance before your committee pointed out that last summer Canada revised its tax laws to provide a 57½-percent effective rate of Canadian tax on income going to U.S. corporations operating in branch or subsidiary form in Canada. He stated that this Canadian tax, in excess of the U.S. 52-percent rate, has highlighted a procedure of using the foreign tax credit as an artificial enducement to the outflow of short-term U.S. capital. The Secretary stated that this was harmful to our monetary stability and balance-of-payments position.

Under existing law, a U.S. corporation deriving income from business abroad through a branch or a subsidiary can be expected to have an unused foreign tax credit if the foreign tax rate exceeds the U.S. rate. However, if additional foreign source income, such as interest, can be earned which is subject to a foreign tax rate which is lower than the U.S. rate, then the two types of income can be combined under the existing foreign tax credit rules. In this way the U.S. tax on the investment funds, which the foreign country taxes at a rate at much less than the U.S. rate, can be reduced or completely eliminated by being offset against the excess credit from the tax on the business income. For example, if U.S.-owned business operations are taxed in Canada at a 57½-percent effective rate, this leaves an excess credit of 5½ percentage points over and above the tax which can be credited against the U.S. 52-percent tax. The Canadian rate of tax on interest income, however, is only 15 percent. As a result, the U.S. company involved may transfer to Canada short-term funds, such as bank deposits, which would ordinarily be held in the United States. The excess credit from the business income in this case eliminates the U.S. tax on all, or a part, of the interest income, with the result that the interest income in effect is taxed at only a 15-percent Canadian rate as compared with the 52-percent U.S. rate which would apply if the funds were held here.

The Secretary of the Treasury stated that the existence of this situation has served as an artificial enducement to the movement of U.S. capital abroad. He recommended that the foreign tax credit for certain investment income be computed apart from the foreign tax credit for all other foreign income, in order to end the use of this device. Your committee is in accord with the Secretary on this provision, except that it has limited the separate computation to interest income which is unrelated to the foreign trade or business.

B. Comparison of committee amendments with House provision

The House bill does not contain this provision.

C. General explanation of provision

Under present law the foreign tax credit which may be taken with respect to any foreign income is limited to the same proportion of the United States tax (computed without the credit) which the taxpayer's taxable income from sources within a foreign country, or all foreign

countries, is of his entire taxable income. This limitation, at the option of the taxpayer, can be applied either separately, i.e., on a per country basis, with respect to the income from each foreign country, or on an aggregate, or overall, basis with respect to all income received from all foreign countries.

Your committee's amendments provide that this limitation on the foreign tax credit is to be applied separately with respect to a certain type of interest income. It also provides that the limitation always is to be applied on a "per country" basis with respect to the specified interest income. Thus, if the taxpayer has been using the overall limitation, this limitation will continue to apply with respect to all income, other than the special interest income, from all foreign countries. However, the limitation will be applied separately for the special interest income derived from each foreign country. If the taxpayer is using the per country limitation, he will be permitted to continue on this basis but will have to apply the limitation separately with respect to the special interest income and other income derived from each country.

The interest income for which the separate computation of the limitation on foreign tax credit is to be made is all interest income, other than interest—

(1) Derived from any transaction which is directly related to the active conduct of a trade or business in a foreign country or possession (such as interest income on accounts receivable by a foreign business arising from its ordinary business transactions);

(2) Income derived from the conduct of a banking, financing or similar business; or

(3) Income received from a corporation in which the taxpayer has at least a 10-percent voting stock interest.

The first exception above includes interest income derived from obligations received where it was necessary to dispose of an active trade or business carried on in a foreign country or U.S. possession or of securities in a foreign subsidiary corporation in which the taxpayer has at least a 10 percent interest.

The bill also provides transitional rules for applying carrybacks of unused credits from years before the separate computation for interest was required to years after such separate computation is required, and also for carryovers from years before such separate computation was required to years after such computation was required. These rules are intended to be applied both where the taxpayer is on a "per country basis" and where he is on an "overall basis." The bill provides that where amounts are carried back to years before this separate computation was required, the new provision can be ignored for the purpose of these carrybacks. Where all of these carrybacks are not used in these prior years, however, and therefore are carried forward to future years, then separate carryforwards are to be provided, determined upon the ratios of the special interest income and other income to total income in the year in which the unused credit arose. Where an unused foreign tax credit is carried forward from a year in which no separate computation was required to a year in which such a separate computation is required, the carryforwards are to be divided between the special interest income and other income in accordance with the ratio of each to the total income in the current year.

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This provision is to apply with respect to taxable years beginning after the date of enactment of this bill but only with respect to interest resulting from transactions consummated after April 2, 1962. This date was selected because it represents the date on which the Secretary of the Treasury appeared before your committee and requested action on this provision.

XI. EARNED INCOME FROM SOURCES OUTSIDE THE UNITED STATES

(Sec. 11 of the bill and secs. 911 and 72(f) of the code)

A. *Reasons for provision*

Under present law an individual citizen of the United States who is a bona fide resident of a foreign country may exclude from his U.S. tax base his entire earned income from sources outside of the United States. In addition, an individual who goes abroad, but does not establish a foreign residence, may exclude from his U.S. tax base his earned income up to $20,000 a year if he remains abroad for a period of 17 out of 18 consecutive months.

The President recommended that in the case of citizens living abroad in developed countries there be no exclusion for income earned abroad. In the case of less developed countries he would keep the present exclusion of up to $20,000 a year in the case of those who are abroad 17 out of 18 months, and also provide the same $20,000 ceiling with respect to those who are bona fide residents of a foreign country.

The House bill provides a ceiling on the exclusion for income earned abroad. However, it does not attempt to distinguish between U.S. citizens residing or present in developed and those in less developed countries. As a result, it retained the 17-out-of-18-month provision of present law without any major change in the presently applicable $20,000 ceiling. In the case of a bona fide resident of a foreign country the House bill also provides the same $20,000 limitation for the first 3 years the individual resides abroad. However, if the individual resides abroad for an uninterrupted period of more than 3 consecutive years a higher ceiling of $35,000 is provided. Thus, during the first 3 years an individual is abroad the exclusion will be the same, whether the individual is a bona fide resident of the foreign country or merely there for 17 out of 18 months. However, in recognition of the fact that those who are abroad for longer periods of time are more dependent on the foreign economy, and less upon the U.S. economy, the higher ceiling of $35,000 is provided in the case of these longer stays.

A second recommendation of the administration in this area relates to pensions and deferred compensation paid to U.S. citizens, after they have ceased to earn income abroad, but with respect to periods of time during which they did earn income abroad.

In the case of pensions generally, an employee receives back over his period of life expectancy (or in some cases in the first 3 years) the amount he paid toward his pension. The remainder of the pension payments he receives, consisting of contributions by the employer and interest on the funds while they were accumulating, is taxable to him as the pension or annuity payments are received.

In the case of a citizen who has been a bona fide resident of a foreign country, or been in a foreign country for a period of 17 out of 18

months or more, the employer's contributions toward the pension fund with respect to him, during the period the employee was abroad are treated in the same manner as his own contributions and, therefore, are not taxable to him when he draws his pension or annuity upon retirement. This is true even though he may be living in the United States next to someone who has worked for the same employer in the United States and is fully taxable on contributions made by the same employer.

To remove this discrimination the House bill provides that contributions by an employer will, to the extent that they relate to future employment, be fully taxable to the employee when he receives the pension payments reflecting these contributions. Thus, for the future even though employer contributions are attributable to a period when the employee was earning income abroad after 1962, these contributions by the employer will be taxable to him in the same manner as in the case of a domestic worker also receiving a pension. This will be true whether the employee is living in the United States, or abroad, at the time of the receipt of the pension payment.

Also, under the House bill where an individual receives deferred compensation after the end of the taxable year following the year in which the services were performed this compensation is not to be eligible for the exclusion for income earned abroad. The purpose of the exclusion is to provide a special inducement for American citizens or residents to hold employment abroad. However, there does not appear to be any reason to provide this special inducement long after the period in which the employment occurred. Moreover, this will treat deferred compensation under the exclusion the same as qualified pensions.

B. Comparison of committee amendments with House provision

Your committee has retained the House provision with respect to the limitations on the exclusion of income earned abroad with but two relatively minor modifications. Your committee also has accepted the House bill's treatment of contributions to a pension plan and of deferred compensation arrangements without change.

One of the changes made by your committee in the exclusion for income earned abroad is to deny any exclusion to an individual as a "bona fide resident of a foreign country" if the individual: (1) has earned income from sources within that foreign country; (2) has filed a statement with the authorities of that country that he is not a resident of it; and (3) has been held not subject to income tax as a resident of that country. This is intended to prevent an individual from avoiding income tax in the United States and the foreign country by taking inconsistent positions with respect to residence in the two countries.

The second change also relates to the exclusion for income earned abroad by bona fide residents of a foreign country. The attention of your committee was called to the fact that some residents of a foreign country have for a long time received certain fringe benefits, which in the past there was no need to value because of the unlimited exclusion. The type of fringe benefits referred to are noncash compensation, such as provision for a home or a car. It has been suggested that it may take some time to properly value these benefits. In addition, it has been suggested that the inclusion of such fringe benefits

in the U.S. tax base will present an adjustment problem for these individuals. To give such individuals time to properly value these benefits and adjust to their new tax status, your committee's amendments provide that these fringe benefits will be entirely excluded from taxable income for a taxable year ending in 1963, will be excluded to the extent of two-thirds for years ending in 1964, and will be excluded to the extent of one-third for years ending in 1965. Thereafter, these amounts will be taxable to the extent that they, together with any cash (or other) income earned by the individual from foreign sources exceed the $20,000 or $35,000 limitation, whichever is applicable.

C. General explanation of provision

1. Ceiling on earned income exclusion.—The bill places a ceiling on the amount which may be excluded from income in the case of a citizen of the United States who is a bona fide resident of a foreign country or countries. The bill provides that the total amount which may be excluded with respect to the first 3 years an individual is abroad as a bona fide resident is $20,000 a year. This is the same ceiling which presently is applicable in the case of citizens or residents of the United States who are abroad for a period of 17 out of 18 months. However, in the case of the U.S. citizen who has been a bona fide resident of a foreign country or countries for more than 3 years, the total amount which may be excluded under the bill in this case (except for the fringe benefits referred to below) is to be $35,000 per year instead of $20,000. This higher ceiling is to apply with respect to any portion of a taxable year remaining after the individual has been a bona fide resident of a foreign country or countries for the unintertupted 3-year period. Where at the time of the passage of this legislation the individual already has been a bona fide resident for 3 years or more, this higher ceiling will, of course, become applicable immediately.

In applying either the $20,000 or $35,000 ceiling under community property laws the total community income excludable may not exceed the amount which would be excludable if this income were not community income. Thus, one $20,000 or $35,000 ceiling will apply with respect to the husband's earnings abroad even though under community property law, half of this income is the income of the wife. However, if both husband and wife are abroad and earn income, separate ceilings will be applied with respect to the earnings attributable to the services of each.

The $20,000 or $35,000 limitation applicable to a bona fide resident of a foreign country is not to apply to certain fringe benefits during a transitional period. The fringe benefits referred to are the right to use property or facilities, such as a home or a car. No part of such compensation received from sources without the United States (unless paid by the U.S. Government) is to be taken into account, and only other earned income in excess of $20,000 or $35,000 will be taxed for taxable years ending in 1963. For taxable years ending in 1964, one-third of the value of this type compensation is to be taken into account and for taxable years ending in 1965, two-thirds of the value is to be taken into account. Thereafter, such compensation will be fully taxable, subject to the $20,000 or $35,000 limitation, in the same manner as any other compensation.

The bona fide resident rule has also been modified to provide that an individual is not to be treated as a bona fide resident of a foreign

country if he has earned income in the foreign country, has made a statement to the authorities of that country that he is not a resident of it, and has been held not subject as a resident of that country to its income tax. This does not prevent an individual from qualifying under the exclusion for presence in a foreign country or countries for 17 out of 18 months. It also does not deny an individual an exclusion as a bona fide resident if, under wholly consistent positions with respect to residence in the United States and a foreign country, he is held by both countries to be a nonresident.

2. Deferred compensation.—Under present law the bona fide resident rule and the 17- out of 18-month rule work somewhat differently in determining the year to which the exclusion relates. The bona fide resident rule at present provides an exclusion without limit for amounts received from sources without the United States which are "attributable" to the period when the U.S. citizen was a bona fide resident of a foreign country. This means that deferred compensation attributable to a period of foreign service is excludable even though received many years after the period of service.

The 17- out of 18-month rule, however, because of the $20,000 ceiling, has been interpreted as limiting the exclusion which an individual may receive to the proportion of the taxable year, during which the payment was *received*, in which the individual was abroad. Thus, where the individual receives deferred compensation after he has been back in the United States for an entire taxable year, no exclusion is available. Moreover, in this latter case, hardship situations have occurred where an individual, who has returned to the United States early in a year, has received payments attributable to service in the prior year, but because the individual is in the United States most, or all, of the year little, or no, exclusion is available with respect to this income.

The bill eliminates the problems referred to above by attributing the income, for purposes of applying the dollar limitation on the exclusion, to the year in which the service is performed. This means that the exclusion, merely because the individual has returned to the United States before receiving the payment, will not be denied. However, most deferred compensation is made ineligible for the exclusion by providing that no exclusion will be allowed for amounts received more than 1 year after the close of the taxable year in which the services are performed.

3. Pension income.—The provision of present law dealing with annuities (sec. 72(f)) provides that in determining what the employee or annuitant paid for an annuity contract, there is to be included contributions of the employer, if, had these contributions been paid to the employee in the first instance, they would not have been taxable to him. This provision generally has the effect of excluding employer contributions to a pension plan from tax (in the year the pension payment is received) where the employee is abroad and qualifies for the exclusion.

The bill nullifies this section by providing that the exclusion for income earned abroad is not to be available in the case of amounts contributed after December 31, 1962, and subsequently received as pensions or annuities or amounts which otherwise would be included in gross income in the case of beneficiaries of tax-exempt trusts (sec. 402(b)), beneficiaries under nonqualified annuities (sec. 403(c)), or

beneficiaries under certain forfeitable contracts purchased by exempt organizations (sec. 403(d)).

The bill also makes it clear that the tax-free status of employer contributions will be continued in the case of contributions made after December 31, 1962, to the extent that they provide pension or annuity credits where these credits are attributable to services performed on or before that date if the pension or annuity plan provisions were in existence on March 12, 1962.

4. Effective date.—The changes made by this provision (except for the fringe benefits exclusion) are to apply to amounts received after December 31, 1962, but only to the extent that these amounts are attributable to services performed after that date or services performed on or before that date, where on March 12, 1962, there did not exist a right to receive these amounts.

XII. CONTROLLED FOREIGN CORPORATIONS

(Sec. 12 of bill and secs. 951–972 of code)

A. Reasons for provision

Under present law foreign corporations, even though they may be American controlled, are not subject to U.S. tax laws on foreign source income. As a result no U.S. tax is imposed with respect to the foreign source earnings of these corporations where they are controlled by Americans until dividends paid by the foreign corporations are received by their American parent corporations or their other American shareholders. The tax at that time is imposed on the American shareholder with respect to the dividend income received, and if this shareholder is a corporation it is eligible for a foreign tax credit with respect to the taxes paid by the foreign subsidiary. In the case of foreign subsidiaries, therefore, this means that foreign income taxes are paid currently, to the extent of the applicable foreign income tax, and not until distributions are made will an additional U.S. tax be imposed, to the extent the U.S. rate is above that applicable in the foreign country. This latter tax effect has been referred to as "tax deferral."

The President in his tax message last year questioned the desirability of providing tax deferral with respect to earnings of U.S.-controlled companies except in the case of investments in less developed countries. In this respect he emphasized removing tax deferral in the case of what have been called "tax havens." Thus he stated:

> The undesirability of continuing deferral is underscored where deferral has served as a shelter for tax escape through the unjustifiable use of tax havens such as Switzerland. Recently more and more enterprises organized abroad by American firms have arranged their corporate structures—aided by artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights, the shifting of management fees, and similar practices which maximize the accumulation of profits in the tax haven—so as to exploit the multiplicity of foreign tax systems and international agreements in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad.

In this area the President recommended the:

> * * * elimination of the tax haven device anywhere in the world, even in the underdeveloped countries, through the elimination of tax deferral privileges for those forms of activities, such as trading, licensing, insurance, and others, that typically seek out tax haven methods of operation. There is no valid reason to permit their remaining untaxed regardless of the country in which they are located.

The House bill did not go as far as the President recommended. It did not eliminate tax deferral generally, but instead was concerned primarily with what had been referred to as "tax haven" devices. To accomplish this result the House bill in general sought to end tax deferral for income derived by U.S. controlled foreign corporations from insurance abroad of U.S. risks; for certain foreign investment income of these corporations; for their income from foreign sales subsidiaries which are separately incorporated from their manufacturing operations; and income invested in "nonqualified property," that is, generally, earnings not needed in the same trade or business or funds indirectly brought back to the United States without full payment of U.S. tax. In most of the categories described above deferral of the tax was not denied where earnings were reinvested in a less developed country. In addition, under the House bill (sec. 6) a special rule was added which in general provided that in the case of sales between a domestic corporation and a foreign controlled corporation the income arising from the transaction was to be divided between the corporations involved on the basis of payroll, assets, and sales or promotional expenses attributable to the United States or the foreign country or countries.

B. Comparison of committee amendments with House provision

Your committee has substituted a provision for the House bill sections 6 and 13 which differs in several important respects from the House bill sections. However, your committee's amendments, like the House bill, also are designed to end tax deferral on "tax haven" operations by U.S. controlled corporations.

In the area of income arising from insurance of U.S. risks, income from passive investments, and income from sales subsidiary operations, your committee's provision is much the same as the House bill. In these areas among the more significant changes are provision for inclusion of passive investment and sales subsidiary income in the tax base of U.S. shareholders only if it represents 30 instead of 20 percent of gross income, and the expansion of the taxable categories to include service income performed for related persons. Also important are the changes relating to exclusions from the tax base for reinvestments of income. Under your committee's amendments reinvestments which reduce the tax base are limited to reinvestments of dividends and interest (or gains on the sale of investments) and these income items must not only be reinvested in less developed countries but also must be derived from such countries as well. However, the qualifying reinvestments are not limited to those in a corporation in a less developed country in which the taxpayer and no more than four other Americans have an interest of more than 50 percent, as was provided by the House bill.

Your committee's amendments differ considerably from the House provision in that they are no longer concerned with the reinvestment of earnings arising from the active conduct of a trade or business, except to be sure that these earnings are not indirectly brought back to the United States in a manner which avoids the U.S. tax. Thus, there is no requirement that such earnings be reinvested in the same trade or business in which the taxpayer has been engaged in the last 5-year period or before December 31, 1962.

A second area in which your committee's amendments differ from the House provision is in the treatment of patents, copyrights, formulas, and processes, etc., developed or acquired in the United States. Under the House bill tax deferral in the case of controlled foreign corporations having such patents, copyrights, etc., was to be denied and the income either actually or constructively attributable to such items was to be taxed to the U.S. shareholders. Your committee's bill, in a separate section (sec. 16), provides for gains from any such patents, copyrights, etc., to be taxed as ordinary gain in most cases at the time of transfer of the patent or other rights from the domestic corporation to the foreign controlled subsidiary.

A third important change in your committee's amendments is the deletion of the income allocation rule provided by section 6 of the House bill.

Your committee's amendments also differ substantially from the House provision in that they provide two major relief provisions, or "escape valves," which may be used by taxpayers to make section 12 inoperative in their case. One of these is designed to make section 12 inoperative where the overall foreign and U.S. taxes paid with respect to the foreign operations is not substantially below what the U.S. taxes would be on the income. Thus, your committee's amendments provide a schedule of effective foreign tax rates and corresponding percentages of distribution which if complied with make section 12 inoperative. The second major relief provision is the export trade corporation provision. This provides, in general, that where the products sold are those produced or grown in the United States, and where the profit attributable to these operations complies with certain specified limitations, then this "export-trade income" is not to be subject to section 12 if the earnings are reinvested in an export trade business.

Your committee's amendments are described briefly below.

C. General explanation of provision

1. *The general pattern of the provisions.*—The bill provides that certain types of income of controlled foreign corporations, even though undistributed, are to be included in the income of U.S. shareholders in the year the income is earned by the foreign corporation. In these cases the shareholders are permitted to take foreign tax credits to the same extent as if actual distributions had been made. Under the bill only U.S. shareholders are taxed on the undistributed income.[1] The U.S. shareholders to be so taxed must, either actually or constructively, have at least a 10-percent interest in the voting power of all classes of voting stock of a controlled foreign corporation. A

[1] U.S. shareholders are defined in the bill as "U.S. persons" with the 10-percent stockholding. U.S. persons, in general, are U.S. citizens and residents and domestic corporations, partnerships, and estates or trusts.

foreign corporation is a "controlled foreign corporation" for this purpose only if more than 50 percent of the combined voting power of all classes of stock is owned directly or constructively by these U.S. shareholders having a 10 percent or greater stock interest.[2]

There are two categories of undistributed income which under your committee's amendments are taxed to the U.S. shareholders of controlled foreign corporations. The first of these categories is referred to as income derived from insurance or reinsurance of U.S. risks. The second category is referred to as foreign base company income. This foreign base company income can in turn be broken down into base company personal holding company income, base company sales income, and base company service income. Collectively, the income derived from insurance or reinsurance of U.S. risks and foreign base company income is referred to in the bill as "subpart F income." The amount of this which may be taxed in any year is limited to the earnings and profits of the controlled foreign corporation for the taxable year less deficits not otherwise offset since 1959.

In addition to certain types of undistributed earnings being treated as if they were distributed and taxed to the U.S. shareholders of controlled foreign corporations, the bill also provides that earnings invested in U.S. property (with certain exceptions) are to be taxed to the U.S. shareholders. In general terms, U.S. property is property located in the United States or having a situs in the United States unless used in the foreign trade or business. Earnings invested in U.S. property are treated first as arising out of subpart F income which means that to the extent that subpart F income is taxed to U.S. shareholders, the income of the corporation will not again be taxed to the U.S. shareholders because of investments in U.S. property. Similarly, actual dividend distributions are treated first as being paid out of earnings invested in U.S. property, then out of subpart F income, and only finally, if any balance remains, out of the accumulated earnings and profits of the corporation which have not already been taxed to the shareholders. Only when actual dividends are treated as paid out of this latter category do they represent taxable dividends to the shareholders.

The earnings of a corporation classified as subpart F income or as investments in U.S. property, give rise to taxable income to the U.S. shareholders only for the portion of the earnings represented by the portion of the year in which the corporation was a controlled foreign corporation. Moreover, the shareholders are taxed only on their allocable share of the earnings with the result that any holdings by foreigners or by Americans having less than a 10-percent interest are not taxed to any shareholders under this provision.

2. Income derived from insurance of U.S. risks.—Since the passage of the Life Insurance Company Income Tax Act of 1959, which for the first time in many years imposed a tax on underwriting gains of these companies, it is understood that a number of the companies involved have attempted to avoid tax on the gains by reinsuring their policies abroad. In other cases the tax has been avoided by placing the initial policy with a foreign insurance company either controlled by an American insurance company or controlled by other American businesses.

[2] The 10-percent holding may be on any day of the taxable year of the corporation A special additional test of control provided in the case of insurance is discussed under the heading of insurance.

To meet this problem the bill provides that where a controlled foreign corporation receives premiums or other consideration for reinsurance or the issuing of insurance or annuity contracts on property in, or residents of, the United States the income attributable to this is to be taxed to the U.S. shareholders as a part of subpart F income. This provision does not apply, however, unless the controlled foreign corporation receives premiums or other consideration for reinsurance or the issuing of insurance or annuity contracts representing U.S. risks which are in excess of 5 percent of their total premiums and other consideration.

The bill also covers the type of situation where the controlled foreign corporation does not hold the policies involving U.S. risks but instead holds other policies which, by arrangement with another corporation, it has received instead of the insurance involving the U.S. risks, while the other corporation holds the policies involving the insurance on property in, or residents of, the United States.

In the case of insurance there also is an alternative definition of a controlled foreign corporation. Under the alternative if U.S. persons hold from 25 to 50 percent of the stock, any income from insurance or reinsurance on U.S. risks is included in income taxed as subpart F income where the U.S. risks represent 75 percent of the gross amount of all premiums and other considerations received with respect to risks held by the company. This alternative rule for control is designed to cover cases where the principal business is the U.S. risks but the control is decreased in order to avoid the application of this provision.

The income subject to tax in the hands of the shareholders in the case of life insurance companies is total gain from operations to the extent attributable to U.S. risks. In effect this represents all (not 50 percent) of the underwriting income as well as net investment income.

3. Foreign base company income.—The second component of the subpart F income which will be taxed to the U.S. shareholders in the case of controlled foreign corporations is foreign base company income. This consists of foreign personal holding company income, foreign base company sales income and foreign base company services income, which are discussed below under paragraph headings *a*, *b*, and *c*. Excluded from this foreign base company income is dividend and interest income from 10-percent-related persons (and gains from the sale or exchange of the underlying investments) which are attributable to certain investments in less developed countries. Also excluded is certain income from shipping. In addition, special rules apply where the foreign base company income represents less than 30 percent or more than 70 percent of the controlled foreign corporation's gross income. A further exception is provided for foreign corporations where it is established to the satisfaction of the Treasury Department that the foreign corporations are not availed of to reduce taxes. These exclusions and special rules are discussed under paragraph heading *d.* below.

a. Foreign personal holding company income.—The income referred to here is income which under other provisions of the code already is defined as "foreign personal holding company income." Generally speaking, this is income which is passive in character. It includes income from dividends, interest, most royalties, annuities, etc. Three modifications made in this definition of "foreign personal holding company income" for purposes of this provision are noted below.

Your committee, while recognizing the need to maintain active American business operations abroad on an equal competitive footing with other operating businesses in the same countries, nevertheless sees no need to maintain the deferral of U.S. tax where the investments are portfolio types of investments, or where the company is merely passively receiving investment income. In such cases there is no competitive problem justifying postponement of the tax until the income is repatriated.

The section adopts the definition of "foreign personal holding company income" appearing elsewhere in the code (sec. 553) with various modifications and adjustments.

First, *all* rental income is included in foreign personal holding company income for purposes of this provision. (Under sec. 553, rent income is only included as foreign personal holding company income if it constitutes less than 50 percent of the gross income of the corporation.)

The second important modification provides that certain income otherwise defined as foreign personal holding company income is not foreign personal holding company income for purposes of this new provision when it arises in connection with certain actual business activities. Specifically, it is provided that rents and royalties received from an unrelated person and derived from the active conduct of a trade or business will not be considered foreign personal holding company income. It is also provided that dividends, interest and gains from the sale or exchange of stock or securities derived in the conduct of a banking, financing or similar business will not be considered foreign personal holding company income. Another exception is made for dividends, interest and gains from the sale of stock or securities derived from the investments made by an insurance company of its unearned premiums or reserves necessary for the proper conduct of its insurance business.

Finally, certain exceptions are made for income received from related parties. Your committee saw no reason for taxing the U.S. shareholders on dividends received by a controlled foreign corporation from a related party where the U.S. shareholder would not have been taxed if he had owned the stock of the related party directly. For this reason, dividends and interest received from a related corporation which is organized under the laws of the same foreign country as the controlled foreign corporation and has a substantial part of its assets used in its trade or business located in that foreign country, are not included in foreign personal holding company income. Rents, royalties, and similar amounts received from a related party (whether or not incorporated in the same jurisdiction) are also excluded from foreign personal holding company income if these amounts are received for the use of property within the country in which the controlled foreign corporation is incorporated. Also excluded from the definition of foreign personal holding company income is interest received by a banking or financial business firm from a related person also engaged in the banking or financing business, if the business of each is predominantly with unrelated persons. This means that the foreign personal holding company income will not arise merely because of normal business transactions between two or more related financial institutions.

b. Foreign base company sales income.—Foreign base company sales income is income derived from the purchase and sale of personal property if the property is either purchased from a related person or sold to a related person. However, this applies only where the property purchased is manufactured, produced, grown, or extracted outside of the country where the controlled foreign corporation is organized and the property also is sold for use, consumption or use outside of that country. The provision also covers similar cases where the controlled foreign corporation does not take title to the property but acts on a fee or commission basis.

The "foreign base company sales income" referred to here means income from the purchase and sale of property, without any appreciable value being added to the product by the selling corporation. This does not, for example, include cases where any significant amount of manufacturing, major assembling, or construction activity is carried on with respect to the product by the selling corporation. On the other hand, activity such as minor assembling, packaging, repackaging or labeling will not be sufficient to exclude the profits from this definition.

The sales income with which your committee is primarily concerned is income of a selling subsidiary (whether acting as principal or agent) which has been separated from manufacturing activities of a related corporation merely to obtain a lower rate of tax for the sales income. This accounts for the fact that this provision is restricted to sales of property, to a related person, or to purchases of property from a related person. Moreover, the fact that a lower rate of tax for such a company is likely to be obtained only through purchases and sales outside of the country in which it is incorporated, accounts for the fact that the provision is made inapplicable to the extent the property is manufactured, produced, grown, or extracted in the country where the corporation is organized or where it is sold for use, consumption, or disposition in that country. Mere passage of title or the place of the sale are not relevant in this connection.

Also included in foreign base company sales income are operations handled through a branch (rather than a corporate subsidiary) operating outside of the country in which the controlled foreign corporation is incorporated, if the combined effect of the tax treatment accorded the branch, by the country of incorporation of the controlled foreign corporation and the country of operation of the branch, is to treat the branch substantially the same as if it were a subsidiary corporation organized in the country in which it carries on its trade or business.

c. Foreign base company services income.—Foreign base company services income is income derived from the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or similar services, but only where they are performed for a related person and are performed outside the country in which the controlled foreign corporation is organized.

As in the case of sales income, the purpose here is to deny tax deferral where a service subsidiary is separated from manufacturing or similar activities of a related corporation and organized in another country primarily to obtain a lower rate of tax for the service income.

d. Exclusions and special rules for foreign base company income.—The three categories of income described above which are called foreign base company income are to be taxed to the U.S. shareholders of a foreign controlled corporation only if this foreign base company

income represents at least 30 percent of the gross income of the corporation. On the other hand, if the foreign base company income exceeds 70 percent of gross income, the entire gross income (reduced by deductions) of the corporation is to be treated as foreign base company income and treated as if it were distributed pro rata to the U.S. shareholders. Thus, where this foreign base company income is relatively minor, the shareholders will not be taxed on any of it; where it is a major factor, they are to be taxed on the entire income of the corporation. Otherwise, only the actual foreign base company income is to be taken into account.

The bill provides that although otherwise classified as foreign base company income, certain categories of income may, nevertheless, not be taxable to the U.S. shareholders of the controlled foreign corporation. The amounts which may not be taxed to these shareholders are dividend and interest income and gains from the sale or exchange of investments, but only if this income or these gains arose from qualified investments in less developed countries and only to the extent that these amounts are reinvested in qualified investments in less developed countries. What constitutes qualified investments in these less developed countries is discussed under paragraph heading (4) below. If a reduction in foreign base company income is granted for an increase in qualified investments in a less developed country and then at a later time these investments are decreased, then to the extent of any foreign base company income previously omitted from the tax base of the U.S. shareholders, there is to be an increase in the income of the controlled foreign corporation taxable to its U.S. shareholders.

This exception for interest and dividend income (and certain gains) from less developed countries is intended to make it possible for a controlled foreign corporation, which is at least in part a holding company, to reinvest dividends and interest obtained from a subsidiary in a less developed country in another subsidiary in a less developed country, without its shareholders being taxed on this income.

Another exception from the application of the foreign base company income is provided for income derived from the use (including the hiring or leasing) of aircraft or vessels used in foreign commerce or services directly related to the use of the aircraft or vessel. This exception was provided by your committee primarily in the interests of national defense. In this regard it was believed desirable to encourage a U.S.-owned maritime fleet and U.S.-owned airlines operating abroad.

A final exception provided from the foreign base company income is for any income received by a controlled foreign corporation, if it is established to the satisfaction of the Treasury Department that with respect to this income the controlled foreign corporation has not effected a substantial reduction of income or similar taxes.

4. *Less developed country corporations.*—As indicated above, interest and dividend income received from 10 percent related persons (and gains on the sale of the underlying investments) may be deducted from the subpart F income which is taxable to the U.S. shareholders of a controlled foreign corporation only if the income was attributable to qualified investments in a less developed country and was reinvested in qualified investments in less developed countries.[3] Provision is

[3] The bill provides for a reduction in subpart F income to the extent of this dividend and interest income from less developed countries or the increase in investments in these countries, whichever is the lesser.

also made for an increase in the income taxable to the U.S. shareholders whenever there is a decrease in qualified investments in a less developed country, to the extent they were initially attributable to dividends or interest of the type referred to above. The concept of less developed country corporations is also used under section 9 of this bill in determining when the "gross-up" of dividend income is not to be applied. In addition, section 15 of the bill makes use of the concept of less developed country corporations, since the ordinary income treatment provided under that provision in the case of certain corporate liquidations and stock sales does not apply where the corporation involved is a less developed country corporation the stock of which was held for more than 10 years.

Qualified investments in less developed countries under this provision consist of stock of a "less developed country corporation" and obligations of such corporations which at their time of acquisition by the controlled foreign corporation had a maturity of 5 years or more. However, for either the stock or obligations to qualify the controlled foreign corporation must own 10 percent or more of the voting power of all classes of stock of the less developed country corporation. In addition, qualified investments also include obligations of a less developed country.

"Less developed country corporations" consist of two categories. First, they include foreign corporations incorporated in a less developed country, which are engaged in the active conduct of a trade or business, which derive 80 percent or more of their income from sources within less developed countries and which have 80 percent or more (in value) of their assets in property generally used in a trade or business in a less developed country or in certain other specified types of associated property. The specific assets in which this 80 percent of the assets must be invested are—

(1) Property used by it in its trade or business in less developed countries;

(2) Money and bank accounts;

(3) Stock and obligations (having a maturity of 5 years or more at time of acquisition) of less developed country corporations;

(4) An obligation of a less developed country;

(5) Investments required because of restrictions imposed by less developed countries;

(6) Certain U.S. property, such as U.S. Government bonds, money, property purchased in the United States for export, etc., which although having a U.S. situs, are excluded from the definition of "U.S. property." (For a more specific listing of the U.S. property exceptions, see par. (5) below.)

The second category of corporation classified as a less developed country corporation are certain shipping or aircraft companies. These corporations must be foreign corporations (not necessarily incorporated in a less developed country) receiving 80 percent or more of their gross income from:

(1) The use (or hiring or leasing for use) in foreign commerce of aircraft or vessels registered under the laws of a less developed country;

(2) From the performance of services directly related to these aircraft or vessels;

(3) From the sale or exchange of such vessels or aircraft;

(4) Dividends and interest received from foreign corporations which are themselves less developed country corporations under the definition contained in this category and in which the corporation in question had at least a 10 percent stock interest; and

(5) Gain from the sale or exchange of stock or obligations of foreign corporations which are less developed country corporations.

In addition, for these shipping or aircraft companies to qualify as less developed country corporations they must have 80 percent or more of their assets invested in assets used for the production of the income described above and in property which although having a situs in the United States is not considered as "U.S. property" (see exceptions listed in par (5) below).

Less developed countries under the bill are defined as foreign countries (other than areas within the Sino-Soviet bloc) or possessions of the United States where the President of the United States has designated such a country or possession as economically less developed.[4] However, the following countries are in no event to be considered as less developed countries:

Australia	Luxembourg
Austria	Monaco
Belgium	Netherlands
Canada	New Zealand
Denmark	Norway
France	Union of South Africa
Germany (Federal Republic)	San Marino
Hong Kong	Sweden
Italy	Switzerland
Japan	United Kingdom
Liechtenstein	

Once a country has been designated as a less developed country, the President is not to terminate that designation without giving 30 days prior notice to the Senate and House of Representatives of his intention to do so. Moreover, if at the time of acquisition, property was qualified investment in a less developed country, this property is to continue to qualify thereafter even though the country ceases to be a less developed country.

5. *Investment of earnings in U.S. property.*—In addition to the income from insurance of U.S. risks and foreign base company income, U.S. shareholders of controlled foreign corporations also are to be taxed on other earnings of the corporation to the extent of the corporation's investments in U.S. property. For this purpose U.S. property is that acquired after December 31, 1962, which is—

(1) Tangible property located in the United States;

(2) Stock of a domestic corporation;

(3) An obligation of an U.S. person; or

(4) Any right to use in the United States a patent or copyright, an invention, model, or design whether or not patented, a secret formula or process, or any other similar property right, but only if any of the foregoing is acquired or developed by the controlled foreign corporation for use in the United States.

[4] Oversea territories, departments, provinces, or possessions for this purpose may be treated as separate countries. Thus, even though the "home" country may be classified as developed, the oversea area may be considered less developed.

Certain exceptions, however, are made to the above categories with the result that the term "U.S. property" does not include—

(1) Investments in U.S. bonds, money, or bank accounts;

(2) Property purchased in the United States for export to, or for use in, foreign countries;

(3) Loans arising in connection with the sale or processing of property where the amount of the loan would be considered ordinary and necessary to carry on the trade or business of both the lending and borrowing corporation had the sale been made between unrelated persons, or in the case of processing, would have been required of the lending corporation had the transaction involving such processing occurred between unrelated persons;

(4) Aircraft, railroad rolling stock, vessels, motor vehicles, or containers used in the transportation of persons or property in foreign commerce predominantly outside the United States;

(5) Assets of an insurance company representing reserves attributable to contracts which do not involve U.S. risks; and

(6) Assets of the controlled corporation equal to the earnings and profits accumulated after December 31, 1962, and taxed as income from sources within the United States, of a foreign corporation engaged in trade or business here.

Generally, earnings brought back to the United States are taxed to the shareholders on the grounds that this is substantially the equivalent of a dividend being paid to them. The exceptions noted above, however, are believed to be normal commercial transactions without intention to permit the funds to remain in the United States indefinitely (except in the case of the last category where full U.S. corporate tax is being paid).

6. *Minimum distribution to domestic corporation.*—A major relief provision under your committee's amendments is that which provides that subpart F income (income from insurance of U.S. risks plus foreign base company income) is not to be taxed to the U.S. corporate shareholders if a schedule of minimum distributions is met. The minimum distribution required varies with the effective foreign tax rate and is as follows:

If the effective foreign tax rate is (percentage)—	The required minimum distribution of earnings and profits after foreign taxes is (percentage)—
Under 10	90
10 or over but less than 20	80
20 or over but less than 30	70
30 or over but less than 40	60
40 or over but less than 42	50
42 or over but less than 44	38
44 or over but less than 46	26
46 or over but not more than 47	14
Over 47	0

The purpose of this provision is to forego any tax on the U.S. shareholders with respect to undistributed income of controlled foreign corporations in those cases where the combined foreign tax and United States (to the extent the latter is paid on the distributed income) is not substantially below the U.S. corporate tax rate. The lower the foreign tax rate is, of course, the greater the distribution must be, and the greater the proportion of the total which must be

subject to U.S. tax, if the aggregate tax is not to be substantially below the U.S. corporate tax rate. Table 2 below shows the combined U.S. and foreign taxes implicit in the schedule set forth in this provision. This is shown both on the assumption that the "gross-up" provision in section 9 applies and that it does not apply.[5] The table also shows the range of combined taxes in each bracket, assuming the application of both the minimum and the maximum effective foreign tax rate is applied in each bracket. It will be noted that the combined effective tax rates range from 42.4 to 47 percent where the "gross-up" provision applies and from 37.9 to 47 percent where it does not. For the most part, however, the combined tax is around 46 percent where the "gross-up" applies and 44 percent where it does not.

TABLE 2.—*Total U.S. and foreign tax burden resulting from minimum distribution schedule applied to $100 of earnings of a controlled foreign corporation*

Assumed effective foreign tax rate	Percent distribution required by schedule	Combined U.S. and foreign tax if dividend is—	
		"Grossed up"	Not "grossed up"
9 percent	90	$47.70	$44.22
10 percent	80	43.60	40.24
19 percent	80	45.40	40.38
20 percent	70	42.40	37.92
29 percent	70	45.10	40.43
30 percent	60	43.20	39.24
39 percent	60	46.80	43.76
40 percent	50	46.00	43.60
41 percent	50	46.50	44.25
42 percent	38	45.80	44.20
43 percent	38	46.42	44.95
44 percent	26	46.08	45.16
45 percent	26	46.82	46.00
46 percent	14	46.84	46.45
47 percent	0	47.00	47.00

Taxpayers are permitted to apply the minimum distribution schedule—

(1) separately for each controlled foreign corporation,

(2) for each chain of controlled foreign corporations,

(3) for all controlled foreign corporations, or

(4) for all controlled foreign corporations other than less developed country corporations.

In addition, taxpayers for purposes of this minimum distribution schedule may treat branches as if they were wholly owned foreign subsidiaries distributing 100 percent of their earnings. For this purpose branches maintained in Puerto Rico or a possession of the United States are taken into account, if they would be controlled foreign corporations if incorporated under the laws of Puerto Rico or the possession, and the gross income of the U.S. shareholder includes income derived from sources within Puerto Rico or the possession.

A taxpayer in computing the minimum distribution may omit income from a foreign corporation if it is established to the satisfaction of the Treasury Department that its earnings were blocked because of

[5] The method of computing the combined tax can be illustrated by the case of the 10 percent foreign tax, 80 percent distribution and no "gross-up" of the dividend. The foreign tax on the $100 in this case is $10, leaving $90 after foreign tax. Of this amount 80 percent or $72 is distributed. A 52 percent U.S. tax on this is $37.44. The credit allowed for foreign taxes paid is $7.20 ($\frac{72}{100}\times$\$10), leaving a net U.S. tax of $30.24. This plus the $10 foreign tax gives a combined tax of $40.24.

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currency or other restrictions imposed by the laws of a foreign country. The minimum distributions referred to above may be computed if the taxpayers so elect for an affiliated group of corporations (eligible to file a consolidated return) in the same manner as if they were a single U.S. corporation.

The effective foreign tax rate referred to in the minimum distribution is determined by expressing the income, war profits, or excess profits taxes paid or accrued to the foreign countries or possessions of the United States by the foreign corporation (or corporations) involved as a percent of the earnings and profits of the foreign corporation (or corporations) plus the foreign taxes themselves. The earnings and profits referred to here are to be determined according to rules substantially similar to those applicable to domestic corporations. Taxpayers, however, will, by regulations, be permitted to depart from the U.S. rules where their books are kept on a different basis and the variations in computations are not important. A distribution may be treated as being made in a year if paid within 60 days after the end of that year or in such longer period as the Treasury Department by regulations prescribes. In addition, if a U.S. shareholder in making its return applies for the minimum distribution schedule and subsequently it is found that, for reasonable cause, it has not met the minimum schedule, then subsequent distributions may be made by the controlled foreign corporation (in a manner prescribed under regulations) and be treated as if they had been made in the earlier qualifying period.

7. *Export trade corporation.*—A second major relief provision provided by the bill is the exception for "export trade corporations." The bill provides that foreign base company income (i.e., foreign personal holding company income, base company sales income and base company service income) in the case of export trade corporations is to be reduced by the amount of their foreign base company income which consists of "export trade income." Thus, the U.S. shareholders of controlled foreign corporations will not be taxed on undistributed income of these corporations (to the extent that it represents foreign base company income) if these controlled foreign corporations are export trade corporations having "export trade income." However, the exclusion for foreign base company income representing export trade income may not exceed the lesser of—

(1) 1½ times "export promotion expenses," (attributable to the otherwise excluded income) or

(2) 10 percent of gross receipts of the export trade corporation from the sale, installation, operation, maintenance or use of the property from which it derives the income which otherwise is excluded. (In the case of commissions or fees, this 10 percent is measured on the same basis on which the commissions or fees are based.)

With the limitations it is not expected that the allocation rule in present law (sec. 482) will be needed in many cases involving export trade corporations.

The export trade income which is to be deferred also is limited to the portion of this income which is invested by the export trade corporation in "export trade assets" (or, more specifically, by the portion of the increase in investments in such assets which is attributable to export trade income which constitutes foreign base company income).

Any amount of export trade income where U.S. taxation has been deferred because of such investments, will subsequently be taxed if there is a decrease in export trade assets.

This provision is intended to continue tax deferral in the case of corporations engaged in export trade who are selling abroad products produced, grown, or extracted in the United States. This is intended as an encouragement to export trade. Nevertheless, limitations are imposed to provide that the income attributed to the export trade corporation is in line with the income actually generated by such activity. This is the function of limiting the export trade income to 1½ times export promotion expenses or 10 percent of gross receipts from the property, whichever is the lesser. Also, the provision is intentionally limited to the extent to which the export trade income receiving the special treatment is used for the expansion of the export trade business, itself.

An "export trade corporation" for this purpose is defined as a controlled foreign corporation which derives 90 percent of its gross income (for the prior 3-year period) from sources without the United States and one which derives 75 percent or more of its gross income (for the same 3-year period) from export trade income. However, if 50 percent or more of the gross income of the controlled foreign corporation (for the same 3-year period) is derived from income from agricultural products grown in the United States, this 75-percent requirement is not to apply.

The "export trade income" is an element in the definition of an export trade corporation and also, to the extent included in foreign base company income, represents the maximum amount of subpart F income upon which tax deferral may be granted. Export trade income is net income from—

(1) the sale to an unrelated person (where there is less than 50-percent common control) for use, consumption, or disposition outside the United States of export property. Export property is property manufactured, produced, grown, or extracted in the United States. (In addition to the sale of export trade property, there also is included commissions, fees, etc., from the performance of services with respect to these sales or with respect to the installation or maintenance of export property);

(2) commissions, fees, and other income from commercial, industrial, or other services performed by an unrelated person outside of the United States in connection with patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, etc., acquired or developed and owned by the domestic corporation involved;

(3) commissions, fees, rentals or other income for the use of export property by an unrelated person or attributable to the use of export property in rendering technical, scientific, or engineering services to an unrelated person; and

(4) interest from certain obligations which are export trade assets.

"Export trade assets" are the type of property in which export trade income must be reinvested if its taxation is to be deferred. Export trade assets are—

(1) working capital reasonably necessary for the production of the export trade income;

(2) inventory of export property, i.e., property manufactured, produced, grown, or extracted in the United States, held for use, consumption, or disposition outside of the United States;

(3) facilities located outside of the United States for the storage, handling, transportation, packaging or servicing of export property; or

(4) evidences of indebtedness executed by unrelated persons in connection with the payment for purchases of export property or services.

As indicated previously, the export trade income (to the extent entering into foreign base company income) which may be deferred is limited to 1½ times "export promotion expenses" or 10 percent of gross receipts from the property from which the export trade arises, whichever is the lesser. "Export promotion expenses" are the following expenses paid or incurred in connection with the export trade income—

(1) a reasonable allowance for salaries or other compensation for personal services,

(2) rentals or other payments for the use of property,

(3) a reasonable allowance for the exhaustion, wear and tear of property, and

(4) any other ordinary and necessary expenses to the extent reasonably allocable to the export trade income.

No expense incurred in the United States is to be treated as an export promotion expense unless at least 90 percent of each category of expense is incurred outside the United States.

8. *Other relief provisions.*—In addition to the minimum distribution schedule and export trade corporation provision which may exclude from the tax base of U.S. shareholders undistributed income of controlled foreign corporations, the bill provides two other important relief measures. First, it provides that a U.S. shareholder who is an individual may elect to be taxed upon any undistributed income of a controlled foreign corporation attributed to him as if he were a corporation rather than an individual. If he makes this election this means that he will be subject to a 30-percent tax on the first $25,000 of undistributed income allocated to him and a 52-percent tax on all income allocated above this level. Against this 52-percent or 30-percent tax rate, credits will be allowed for income and other creditable taxes paid by the controlled foreign corporation to foreign countries in the same manner as if the individual were a domestic corporation.

The purpose of this provision is to avoid what might otherwise be a hardship in taxing a U.S. individual at high bracket rates with respect to earnings in a foreign corporation which he does not receive. This provision gives such individuals assurance that their tax burdens, with respect to these undistributed foreign earnings, will be no heavier than they would have been had they invested in an American corporation doing business abroad.

If an individual has elected with respect to the earnings of a controlled foreign corporation to be treated as if he were a domestic corporation, and then subsequently an actual distribution is made, the bill provides that he then is to be taxed only on the excess of the amount received over the amount of taxes he previously paid with respect to the undistributed income. Therefore, if the individual were to be taxed on $100 of undistributed income at a 52-percent tax

rate, and then subsequently the $100 was paid to him as a dividend, he would be taxed at individual income tax rates only on $48, namely, the excess of the amount distributed to him over the taxes he previously paid, assuming the foreign country involved had no income taxes.

Another relief provision is provided with respect to any undistributed income representing "foreign base company income." The bill provides that such income is not to be taxed to the U.S. shareholder if it is established to the satisfaction of the Secretary of the Treasury or his delegate that the incorporation of the controlled foreign corporation in the particular foreign country involved does not have the effect of substantially reducing income, excess profits or similar taxes.

9. Treatment provided in the case of Puerto Rico and U.S. possessions.—The bill provides that a controlled foreign corporation does not include a corporation incorporated in Puerto Rico or a possession of the United States if 80 percent or more of the gross income of the corporation (for the prior 3-year period) is derived from sources within Puerto Rico or a possession of the United States, and if 50 percent or more of the gross income was derived from the active conduct within Puerto Rico or a possession of the United States of specified trades or businesses. The trades or businesses qualifying are the following:

(1) manufacturing and processing of goods or other tangible personal property,

(2) the processing of agricultural or horticultural products (including livestock, poultry, or fur-bearing animals),

(3) the catching of fish (whether or not on the high seas) or extraction of natural resources, or the manufacturing or processing of commodities obtained from such activities, or

(4) the ownership or operation of hotels.

Your committee has excluded Puerto Rico and U.S. possession corporations from the operation of section 12 in recognition of their special status and our special interest in encouraging investments in such areas. The definition of the excluded corporations parallels (except for the reference to the specific trades or businesses) the provision in existing law which excludes from U.S. tax qualifying businesses carried on in the possessions.

In addition to excluding these Puerto Rican or U.S. possessions corporations from the application of section 12, your committee has also provided that the term "U.S. person" (and, therefore, the term U.S. shareholder) does not include in the case of a corporation organized under the laws of Puerto Rico an individual who is a bona fide resident of Puerto Rico (within the meaning of sec. 933(1)); with respect to a corporation organized under the laws of the Virgin Islands does not include an individual who is a bona fide resident of the Virgin Islands and whose income tax obligation is satisfied by paying tax on income derived from all sources into the treasury of the Virgin Islands and in the case of a corporation organized under the laws of any other possession, does not include a bona fide resident of that possession (qualifying under sec. 932(a) of the code).

The effect of not treating these bona fide residents as U.S. persons is to provide that they do not qualify as U.S. shareholders in determining whether or not more than 50 percent of a foreign corporation is controlled by 10-percent U.S. shareholders.

10. Miscellaneous provisions.—

a. Foreign tax credit.—U.S. shareholders who are taxed on subpart F income, on a decrease in investments in less developed countries, or on the increase of earnings invested in U.S. property, can obtain a foreign tax credit for foreign income, etc., taxes paid by the foreign corporation, if the shareholder is a person to whom such a foreign credit would be allowed in the case of an actual distribution. That means that foreign tax credits will be allowed where the shareholder is a domestic corporation (or an individual electing to be treated as a domestic corporation) holding the stock of a foreign corporation and has at least a 10-percent voting stock interest. Similarly, where a domestic corporation has at least a 10-percent interest in a foreign corporation which in turn has at least a 50-percent voting stock interest in a subsidiary, then a foreign tax credit will be allowed the U.S. shareholder with respect to the earnings of this subsidiary when undistributed earnings of the subsidiary are taxed to the U.S. corporate shareholder. Taxes so allowed as credits will not again be allowed as credits when actual distributions are made.

Where the foreign country imposes a tax directly on dividend distributions, such a tax would not, of course, initially be taken into account when the shareholder at an earlier date was taxed on undistributed earnings of a controlled foreign corporation. These taxes on actual dividend payments, however, will be allowed as credits in the year in which the actual dividends are paid, even though these dividends are not taxable to the domestic corporation receiving them because of an earlier inclusion by it of these amounts in its income. Adjustments are made in the overall and per country limitations to keep these limitations from reducing the creditable taxes in such cases below what could be credited if the income taxed and taxes attributable to this income had been taken into account in the same year. Moreover, if the taxpayer has insufficient U.S. income tax against which to offset such credits in the year of the actual distribution, then refunds are allowed.

b. Adjustments to basis of stock.—It is necessary where amounts not actually distributed to the taxpayer are nevertheless taxed to him, to increase his basis for the stock in the controlled corporation by the amount so taxed to him. However, if subsequently actual distributions are made which do not result in any tax to the shareholder because of the prior tax payment by him, then the basis of the stock needs to again be reduced. The bill makes provision for these adjustments.

c. Other provisions.—The bill provides that earnings and profits of a foreign corporation for purposes of this provision are to be determined according to rules substantially similar to those applicable to domestic corporations under regulations prescribed by the Secretary or his delegate. The bill provides that earnings and profits of a controlled foreign corporation are not to be taxable to the U.S. shareholder when it is established to the satisfaction of the Secretary or his delegate that such earnings are blocked because of currency or other restrictions or limitations imposed by the laws of any foreign country.

11. Effective date.—This provision applies to taxable years of foreign corporations beginning after December 31, 1962, and to taxable years of U.S. shareholders within or with which these taxable years of the foreign corporations end.

XIII. GAIN FROM DISPOSITION OF CERTAIN DEPRECIABLE PROPERTY

(Sec. 13 of bill and secs. 1245, 167(f), 170(e), 453(d) and 613(a) of code)

A. Reasons for provision

Under present law, in the case of depreciable property the taxpayer may write off the cost or other basis of the property over the period of the useful life of the asset in his hands. This cost or other basis can be written off evenly (i.e., in a "straight line" over the asset's life), under the declining balance method, under the sum-of-the-year's digits method, or under any other consistent method which does not during the first two-thirds of the useful life of the property exceed the allowances which would have been allowed under the declining balance method. The depreciation deduction is a deduction against ordinary income. If either the useful life of the asset is too short, or the particular method of depreciation allows too much depreciation in the early years, the decline in value of the asset resulting from these depreciation deductions may exceed the actual decline. Wherever the depreciation deductions reduce the basis of the property faster than the actual decline in its value, then when it is sold there will be a gain. Under present law this gain is taxed as a capital gain, even though the depreciation deductions reduced ordinary income. The taxpayer who has taken excessive depreciation deductions and then sells an asset, therefore, has in effect converted ordinary income into a capital gain.

The President stated that our capital gains concept should not encompass this kind of income. He indicated that this inequity should be eliminated, especially in view of the proposed investment credit for newly acquired property. He states that we should not encourage the further acquisition of such property through tax incentives as long as the loophole remains.

This problem also is of major significance in connectoin with the recent depreciation liberalization announced by the Treasury Department. Under this new approach, many taxpayers will be permitted to depreciate assets faster for tax purposes than has previously been the case. Therefore, additional ordinary income would be converted into capital gain if this were not dealt with in this provision.

B. Comparison of committee amendments with House provision

Both the House bill and your committee's amendments treat as ordinary income any gain on the sale or other disposition of certain depreciable property to the extent of the depreciation deductions taken. However, this treatment will apply to property subject to the allowance for depreciation which is either (1) personal property or (2) certain other tangible property but not including a building or its structural components. The bill as passed by the House did not apply this treatment to buildings or structural components thereof, and your committee has not changed this feature of the House-passed bill.

The House bill applied to property disposed of after the date of enactment of this bill and provided that the only gain which was to be treated as ordinary income was to be depreciation occurring in 1962 and subsequent years. The bill, as amended by your committee, will only apply to sales, exchanges, or other dispositions occurring

during taxable years beginning after December 31, 1962. However, as under the House bill, in such dispositions, depreciation occurring in 1962 and subsequent years will result in ordinary income.

Your committee concurs with the House in believing that the new treatment of gain on sale will make it possible to be more lenient in determining salvage value. The bill as passed by the House provided that the salvage value for depreciation purposes of an asset may be reduced by up to 10 percent of its cost or other basis, and if this value is less than 10 percent of basis it may be disregarded altogether.

The bill as passed by the House provides that for a period of time after the new ordinary income treatment becomes applicable, taxpayers will have a new election to change their method of depreciation from any declining balance or sum-of-the-years digits method to the straight-line method. This provision has been retained by your committee.

The above description has been in terms of the sale or exchange of a depreciable asset. There are, of course, other methods of disposing of an asset which also are dealt with in this provision. In the case of a gift or a transfer at death no gain is recognized at the time of the disposition of the asset. In the case of a gift, however, the ordinary income potential of the depreciation deductions carries over into the hands of the donee. In the case of gifts to charity, although no ordinary income is recognized at the time of the gift, the charitable contribution is reduced by the amount which would be recognized as ordinary income if the property were sold. Generally, in other cases any gain which under present law would be recognized at the time of the disposition of an asset will be treated as ordinary income to the extent of any depreciation deductions taken. In certain cases, however, in order to prevent tax avoidance the bill provides for the recognition of ordinary income on the disposition of an asset even though gain might not otherwise be recognized. This is true in certain cases where a distribution is made by a corporation or partnership. These provisions have been accepted by your committee.

Your committee has, however, added a new provision providing for an appropriate adjustment in computing the "taxable income from the property" for purposes of the limitation on percentage depletion in the case of mining. This provision is explained below.

C. General explanation of provision

1. *General rule.*—The general rule (in sec. 1245) provides that ordinary income is to be recognized in the case of sales or exchanges to the extent the so-called recomputed basis, or the amount realized in the sale or exchange, whichever is lesser, exceeds the basis of the property in the hands of the person making the sale or exchange. "Recomputed basis" is defined generally as equaling the adjusted basis plus the depreciation deductions previously taken. The excess of the amount realized over the adjusted basis is, of course, the amount presently recognized as capital gain. Since the rule requires that the smaller of these two amounts be treated as ordinary income, this in effect means that the ordinary income in the usual case is to be the gain realized or the sum of the depreciation deductions taken, whichever is the smaller. Where there is a disposition of an asset without a sale or exchange, gain is determined by reference to the fair market value of the asset.

Since this provision is to have prospective application only, in computing depreciation for this purpose only depreciation deductions occurring after December 31, 1961, are to be taken into account. Depreciation deductions for this purpose include not only regular depreciation deductions but also the special initial allowance deduction and any deduction for the amortization of emergency facilities. The special reduction in basis of property provided in connection with the investment credit (sec. 2 of this bill) is not, however, treated as a depreciation deduction for this purpose. Therefore, any gain on sale attributable to this basis adjustment will still result in capital gain (if gain from the property otherwise would be capital gain). The depreciation deductions taken into account are not limited to those taken by the taxpayer, but also include deductions taken by others from whom the taxpayer acquired the property, if the basis of the property was carried over from the transferor. This would not be true where the taxpayer acquired the property from another by reason of the latter's death, since in this case the property receives a new basis at death and this provision does not apply. The general rule is that the depreciation deduction taken into account for each year is the amount allowed or allowable whichever is greater. However, a special rule provides that the depreciation deductions taken into account as to any year will be the amount "allowed" rather than the amount "allowable" if the former is smaller and the taxpayer can establish what the amount was.

The type of property receiving the ordinary income treatment described above is (1) personal property (other than livestock), including intangible personal property, and (2) other property which is tangible, not including a building or its structural components, which is an integral part of certain specified business activities or which constitutes research or storage facilities used in connection with these activities. The activities specified are manufacturing, production, or extraction, or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services.

The ordinary income treatment provided by this section will be applied upon the sale of all property the acquisition of which could have resulted in an investment credit (sec. 38 of the code as added by this bill). However, the ordinary income treatment may also apply to the disposition of property even though the acquisition of this specific property did not result in an investment credit. For example, no investment credit may have been allowed upon the acquisition of the property because (1) its expected useful life was less than 4 years; (2) it was to be used outside of the United States; (3) it was to be used by tax-exempt organizations or governmental units; or (4) it was not new when acquired (and was over the $50,000 limit), etc.

2. Exceptions.—Except as specifically provided in the bill, the ordinary income treatment applies at any time property is disposed of. The bill, however provides six general categories of exceptions to this rule. The first exception is for gifts. As pointed out above, however, the depreciation deductions of the donor must be taken into account by the donee, and may result in ordinary income to him if he sells the property. In the case of depreciable property which is given to a charitable organization, although no income is realized by the donor at the time of the gift, the amount of the charitable contribution deduction he may receive is reduced by the amount which would have

been treated as ordinary income had the property been sold at its fair market value (an amendment adding a new sec. 170(e)).

A second exception to the realization of ordinary income upon the disposition of depreciable personal property is provided in the case of transfers at death (except where the sale has occurred before death and the income is treated as income in respect of a decedent under sec. 691). In this case, however, there is not a carryover of the income potential in the depreciation deductions to the decedent's legatee or heir.

A third category of exceptions to the realization of ordinary income is provided in the case of a series of transactions which generally are tax free and in which the basis is carried over. However, in these transactions where there is any gain recognized, because the exchange is accompanied by "boot" (i.e., money or its equivalent) then to the extent of this gain, ordinary income may be realized (unless the depreciation deductions are smaller). The tax-free transactions referred to relate to those occurring upon the complete liquidation of a subsidiary (sec. 332); in the case of a transfer for stock or securities to a corporation controlled by the transferor (sec. 351); in the case of a transfer by a corporation which is a party to a reorganization of property in pursuance of a plan of a reorganization solely for stock or securities in another corporation also a party to the reorganization (sec. 361); and in the case of reorganizations in certain receivership and bankruptcy proceedings (sec. 371(a) and sec. 374). Also included in the same category are contributions of property to a partnership in exchange for an interest in the partnership, and distributions by a partnership in partial or complete liquidation of an interest (but in this respect see the special partnership treatment described below). Despite the above rule there would be a recognition of ordinary income where there is a contribution of depreciable property to a tax-exempt organization (other than a tax-exempt farm cooperative) in exchange for stock or securities in the exempt organization. Recognition of ordinary income in this case is provided because a disposition of the property by the exempt organization would not ordinarily give rise to the realization of ordinary income with respect to the depreciation deductions.

Another exception is provided in the case of so-called like kind exchanges of property used for production or investment, and for involuntary conversions. In exchanges of these types, the ordinary income realized is not limited to any gain recognized, but also includes gain taking into account the fair market value of nondepreciable or other nonqualifying property acquired in exchange for depreciable property. The realization of ordinary income (to the extent of the depreciation deductions) is necessary in such cases since in the case of property, other than depreciable personal property, there is no opportunity for subsequent recovery of the ordinary income element. A similar exception is provided in the case of the exchange or sale of property in obedience to Federal Communications Commission orders or orders of the Securities and Exchange Commission (secs. 1071 and 1081). In these cases also, the ordinary income realized is not limited to the gain recognized, but also includes any unrecovered depreciation charges with respect to exchanges of depreciable personal property for other types of property.

Special rules are also provided in the case of distributions of depreciable personal property by a partnership to a partner. A distribution of depreciable personal property by a partnership to a partner, to the extent that the distribution accounts for the partner's share of gain attributable to this property, is not to result in ordinary income to the distributee partner at the time of the distribution. However, the ordinary income potential of depreciation deductions taken by the partnership (or by any earlier transferee from whom the partnership acquired property without realization of gain) will be carried over to the distributee partner. When he disposes of this property, the ordinary income potential of these partnership (or prepartnership) depreciation deductions will be taken into account in a manner substantially the same as that applying where the taxpayer himself took the depreciation deductions. The property distributed is given a "recomputed basis" to the partner equal to the basis of the property in the hands of the partner plus any ordinary income gain on which the partnership would have been taxed had the property been sold by it (at its fair market value) immediately before the distribution.

The rule described above applies only to the extent a partner is considered as receiving his share of the property representing ordinary income gain. An amendment made elsewhere to the code (sec. 751(c)) provides that in other cases the ordinary income element in depreciable property is to be considered as an "unrealized receivable." Thus, to the extent of depreciation deductions taken (or potential gain if smaller) ordinary income will be realized in the case of the sale of a partnership interest, in the case of a distribution to a retiring or deceased partner, and in the case of distributions to a partner where he receives either more or less than his proportionate share of property reflecting this type of gain.

3. Dispositions resulting in ordinary income where no gain is presently recognized.—In a series of situations your committee found it necessary to recognize ordinary income even though capital gain in such situations is not recognized under existing law. This was done primarily in those cases where the transferee receives another basis for the property than that of the transferor. This treatment is provided in three types of cases where a distribution is made by a corporation without the payment of a tax at the corporate level on unrealized appreciation in value: namely, where the property is distributed as a dividend (under sec. 311), where the property is distributed in a partial or complete liquidation by a corporation (sec. 336), and where in a plan of complete liquidation a corporation sells the depreciable personal property (and perhaps other assets) and within a 12-month period completes the liquidation of the corporation (sec. 337). Similarly, if the property is first sold by a corporation for installment notes and the gain which would be realized on such sale is delayed because of the installment method of reporting, a distribution of these notes to the shareholders in a liquidation under section 337 (12 months' liquidation) results in the recognition of the same amount of ordinary income to the corporation as would have been realized on a cash sale of such notes. The same rule is applied whenever similar installment notes are distributed by a corporation in a liquidation in which the basis of the property to the receiving shareholder is determined under section 334(b)(2) (purchase of 80 percent of the stock of one corporation by another followed by

the immediate liquidation of the corporation acquired). The other situations where ordinary income may be realized under this provision, although capital gain would not otherwise occur, include the case where a distribution is made by a partnership and the partner gives up, or acquires, more than his proportionate share of this property. Other cases involve the provisions relating to the exchange of "like kind" property, involuntary conversions, sales or exchanges to effectuate FCC policy, and exchanges in obedience to orders of the SEC. In all of these cases where the property received in exchange for depreciable personal property is not itself depreciable personal property, then ordinary income is recognized.

4. Computation of taxable income for purpose of limitation on percentage depletion deduction.—The attention of your committee was called to the fact that the House bill worked a hardship on certain mining properties. At the time the depreciation deductions were initially taken they reduced the "taxable income from the (mining) property." Because percentage depletion deductions are limited to 50 percent of the taxpayer's taxable income from the mining property, in many cases this meant smaller deductions for percentage depletion. Under the House bill part of these depreciation deductions were recouped as ordinary income at the time of the sale of the depreciable property but no comparable upward adjustment was made to the taxable income from the mining property for purposes of percentage depletion.

Your committee has removed this discrimination against mining properties by amending the percentage depletion provision of existing law (sec. 613(a)) to provide that for purposes of the limitation restricting the percentage depletion deduction to 50 percent of taxable income, this income, in case of mining, in effect is to be increased by the amount of gain taxed as ordinary income (under sec. 1245) which is allocable to the property. This increase in taxable income, however, is made *only* for purposes of computing taxable income from the property for the 50-percent limitation, and for no other purpose. The amendment is accomplished by reducing the deductions taken into account with respect to the expenses of mining, used in computing the taxable income from the property, by the portion of any gain treated as ordinary income. This avoids any effect on the computation of "gross income from property" (as defined in sec. 613(c)). No change is made in existing law with regard to the treatment of losses resulting from the sale of depreciable personal property used in exploiting a mineral property.

5. Salvage value.—The bill also amends the code (a new subsec. (f) in sec. 167) to provide that in computing the basis on which depreciation may be taken for personal property, salvage value may be ignored to the extent of an amount equal to 10 percent of the cost or other basis for the property. Thus, if the expected salvage value equals 8 percent of the basis of the property, the entire basis may be written off in depreciation charges by the taxpayer. If the expected salvage value is 12 percent, all but 2 percent of the basis of the property can be taken into account in computing depreciation charges. The provision applies to depreciable personal property (other than livestock) with a useful life of 3 years or more acquired after the date of enactment.

6. *Change in method of depreciation.*—Your committee recognized that some taxpayers who have been following liberal depreciation policies may desire to follow more conservative policies in order to avoid the possibility of ordinary income treatment at the time of sale, as provided by the bill. Therefore, the bill provides that a taxpayer may elect to change his method of depreciation with respect to depreciable personal property from any declining balance or sum of the years digit method to the straight-line method. The right to make this election will be available on or before the date for filing the return (including extensions of time) for the first taxable year beginning after December 31, 1962.

7. *Effective date.*—This provision is to apply with respect to depreciation attributable to periods after December 31, 1961, and as to dispositions of property during taxable years beginning after December 31, 1962. However, the provision relating to salvage value generally is effective for taxable years beginning after 1961.

XIV. FOREIGN INVESTMENT COMPANIES

(Sec. 14 of the bill and secs. 312(l), 1246 and 1247 of code)

A. Reasons for provision

For the small investor who desires to diversify his shareholdings through the use of domestic mutual funds, or regulated investment companies, present law provides that if a series of conditions are met, including the distribution of at least 90 percent of the earnings of the regulated investment company, no tax is imposed on the investment company to the extent it distributes its earnings. Thus, if a domestic company distributes its income currently, present law provides for the imposition of a single, rather than a double, tax, and that one is imposed on the investor rather than the company.

Increasingly in recent years, however, some taxpayers have sought to avoid this tax by investing in foreign investment companies rather than domestic companies. Under present law a foreign investment company usually pays no U.S. income tax, since U.S. tax is imposed only on income derived from sources within the United States and such companies generally have no U.S. securities and, therefore, have no income from U.S. sources. The U.S. shareholders of one of these investment companies are likely to pay a U.S. tax with respect to such investments only when they sell the stock and then, of course, this gain is taxed as a capital gain rather than ordinary income. The U.S. shareholder would, of course, pay tax on any dividend income received from such a company, but most of these companies follow the announced policy of reinvesting all of their income in stocks or bonds in order to prevent the imposition of any such dividend tax by the United States.

The tax avoidance occurring in the case of these foreign investment companies is a matter to which study has been given since 1956. Since that time the seriousness of this problem has increased substantially. The Secretary of the Treasury in his testimony before your committee stated:

> There are currently 13 of such companies, most of them Canadian, registered with the Securities and Exchange Commission, having total assets of $422 million. In addition, there are apparently many more companies not so registered.

It was proposed by the administration that the preferential treatment for investments in these foreign investment companies be eliminated by requiring U.S. shareholders in such companies to pay tax currently on their share of the income derived from the foreign investment company. The provisions included in the House bill achieve much the same result but without attempting to look through the foreign corporation to the American shareholders.

The House bill in general terms provides that American shareholders in these foreign investment companies, when they sell or redeem their stock, are to be taxed at ordinary income rates on their share of any earnings and profits accumulated in the foreign investment company since December 31, 1962, or since the date they acquired the stock, whichever occurred more recently. However, it also provides that this treatment can be avoided at the election of the foreign investment company if it distributes 90 percent of its taxable income other than net long-term capital gains currently and if it informs the U.S. shareholders of their share of any net long-term capital gains. However, for this treatment to apply, the U.S. shareholders must also include in income their share of capital gains whether or not distributed. The distributions of ordinary income in this case, since they are actual distributions, would, of course, in any case be reported for tax purposes by the U.S. shareholders.

B. Comparison of committee amendments with House provision

Your committee has retained the House provision on foreign investment companies with three relatively minor modifications.

Your committee recognized that with the removal of the tax advantages for these corporations in being foreign corporations, many of them may desire to become domestic corporations treated as regulated investment companies. However, under present law when a foreign corporation is a party to a reorganization in which all of its properties are acquired by a domestic corporation, clearance must be obtained from the Internal Revenue Service to the effect that the reorganization is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. Failure to obtain such a clearance results in the imposition of capital gains tax on any appreciation of value. Since your committee has allowed a foreign investment company which has been registered with the SEC the right to elect to have its shareholders treated in a manner substantially similar to that accorded to domestic regulated investment companies, it does not believe that there is tax avoidance if such a company is a party to a reorganization in which all of its properties are acquired by a domestic regulated investment company. Moreover, it believes that the conversion of these companies to domestic companies simplifies the operation of the tax laws in the case of their shareholders. For these reasons, it is provided that this clearance from the Internal Revenue Service under section 367 need not be obtained in the case of one of these foreign investment companies registered with the SEC if it is a party to a reorganization in which all of its properties are acquired by a domestic regulated investment company before January 1, 1964. However, this treatment is to be available only if, for the year 1963, the corporation elected to distribute at least 90 percent of its ordinary income to its shareholders and either distribute, or treat as distributed, the excess of its net long-term capital gain over its net short-term capital loss.

The election provided foreign investment companies by the House bill, to distribute most of their ordinary income currently and to require their shareholders to report their share of the company's capital gains (whether distributed or not), provides tax treatment for these foreign investment companies which is substantially similar to that now applicable to domestic regulated investment companies. However, where domestic regulated investment companies have more than 50 percent of their assets invested in securities in foreign corporations, present law permits the foreign tax credit, for which the regulated investment company itself would otherwise be eligible, to be passed on down to the shareholders. Your committee's amendments, in the interest of conforming the treatment for these foreign investment companies to that provided for the domestic regulated investment companies, provides a similar option in their case to pass down through to the shareholders their foreign tax credits.

Your committee has also extended from 30 to 45 days the period of time elapsing after the end of the taxable year before the investment companies must report to their shareholders their share of the undistributed capital gains which they must take into account for tax purposes. Other technical changes are also made.

C. General explanation of provision

As indicated above, the bill provides alternative tax treatment for shareholders of foreign investment companies. Unless an election is made to the contrary, ordinary income treatment, to a limited degree, is provided at the time an investor in a foreign investment company either sells his stock or it is redeemed. However, if the company has elected to distribute most of its taxable income and the shareholders report capital gain, whether or not distributed, then at their election the ordinary income treatment at the time of the sale of the stock is not to apply. These two alternative provisions are discussed below.

1. Ordinary income treatment on sale of stock.—The bill provides that on the sale or exchange of stock in a foreign investment company after December 31, 1962, any gain realized is to be treated as ordinary income, rather than a capital gain, to the extent of the taxpayer's share of the company's earnings and profits accumulated in years beginning after December 31, 1962. For this purpose the taxpayer's share of these earnings and profits is limited to those attributable to his stock which have been accumulated during the period he has held the stock (excluding any earnings taxed to him when the company was a foreign personal holding company or a controlled foreign corporation). Had the company been a domestic company, currently distributing most or all of its earnings, these same earnings would have been taxable to him. Thus, this provision is not designed as a penalty tax, but merely to accord, to the extent practicable, the same tax treatment as that provided for domestic regulated investment companies.

To give assurances that this ordinary income will not escape tax where the shareholder holds the stock until death, the bill provides that the step-up in basis, or increase in value, which would otherwise occur at date of death is not to occur with respect to the amount which would be ordinary income to the decedent had he sold the stock just before death. Thus, when the estate, heir, or legatee sells the stock,

the same amount (assuming the stock has not gone down in value) will still result in ordinary income and will be subject to U.S. tax at that time. However, the estate, heir, or legatee in such a case can treat this as "income in respect of a decedent." Thus, in computing his ordinary income tax he will be allowed a deduction for any estate tax attributable to inclusion in the decedent's estate tax base of the amount taxed as ordinary income.

Without regard to this provision, where a shareholder sells or exchanges stock in one of these foreign investment companies after holding it for not more than 6 months, the gain is short-term capital gain. Since this type of gain is treated much like ordinary income for tax purposes, the bill provides that if stock in a foreign investment company is held for 6 months or less the provision is not to apply.

A foreign investment company, for purposes of this provision, is defined as a foreign corporation, either registered under the Investment Company Act of 1940 as a management or unit investment trust, or any other corporation engaged primarily in the business of investing, reinvesting, or trading in securities where more than 50 percent of the voting stock (and total value of all shares) is held directly or indirectly by U.S. persons. "United States persons," a definition added to the code by the foreign trust provision in this bill (sec. 7), means a citizen or resident of the United States, a domestic partnership, a domestic corporation, and a domestic estate or trust.

To prevent avoidance of this ordinary income tax treatment through the use of tax-free (or partially tax-free) exchanges in which stock in a foreign investment company is exchanged for other stock (in a tax-free incorporation or contribution to capital under sec. 351), the bill provides that the substituted stock in such a case (where its basis is determined by reference to the basis of stock in a foreign investment company) is to be treated substantially as if it were the foreign investment company stock. Thus, upon its sale, any gain to the extent of the appropriate share of the foreign investment company's earnings and profits during the period it and the substituted stock was held is to be treated as ordinary income.

The bill also contains several other provisions similarly designed to prevent the avoidance of the ordinary income treatment through indirect ownership of the foreign investment company stock through certificates in a trust, through stock in a domestic corporation, or through a partnership. In this respect it is provided first that a share of stock in a domestic corporation or a trust certificate is to be treated as foreign investment company stock to the extent it represents such stock. Secondly, it is provided that if a company is a member of an affiliated group (with a 50-percent rather than an 80-percent stock-ownership requirement), then the earnings and profits of the entire group are to be allocated under regulations prescribed by the Treasury Department in a manner to carry out the purposes of the bill. Thus, where a foreign corporation is a holding company in the sense that it holds the stock of one or more foreign investment companies, the shareholders of the holding company will not be permitted to avoid ordinary income on the sale of the foreign holding company stock merely because the earnings and profits of the investment company (or companies) have not been distributed to the holding company. Thirdly, the bill provides that the ordinary income treatment is to apply to redemptions of stock by a foreign investment company which would

otherwise be treated as sale transactions because of section 302(a) (disproportionate buy-out of a shareholder) or because of section 303 (a redemption of stock to pay death taxes). Finally, the bill deals with the sale or exchange of and also certain distributions with respect to partnership interests. The bill provides that if any of the property of the partnership is stock in a foreign investment company and would have resulted in ordinary income had it been sold by the partnership itself, then this amount is to be treated as an inventory item. Thus, the sale of the partnership interest (and distributions in certain cases) will generally result in the incurring of ordinary income treatment with respect to the foreign investment company stock underlying the partnership interest.

The bill provides that the shareholder upon sale of the stock must establish the amount of the accumulated earnings and profits of the foreign investment company and his share of these earnings during the period of his investment. If he does not do so, the entire gain will be treated as ordinary income. This information, of course, is necessary to determine the amount subject to ordinary income tax. In addition, the bill provides that every U.S. person owning 5 percent or more in stock of a foreign investment company is to furnish with respect to such a company such information as the Secretary of the Treasury deems necessary in order to properly enforce the tax provisions applicable to shareholders of these companies.

Your committee's amendments also provide that the clearance of the Internal Revenue Service, required by section 367 of the code, need not be obtained where a foreign investment company registered under the Investment Company Act of 1940 is a party to a reorganization in which all of its properties are acquired before January 1, 1964, by a domestic regulated investment company. However, for this clearance not to be required in such cases the foreign investment company must have elected to distribute most of its income currently (as provided under sec. 1247) for its taxable years beginning after December 31, 1962.

2. Election to distribute income currently.—Foreign investment companies which are registered with the SEC to sell stock in this country can elect to make the provision described above inapplicable under certain conditions. Any such election must be made before December 31, 1962.

For the provision referred to above to be inapplicable the electing foreign investment company must agree with respect to the current and all subsequent years to—

(1) distribute 90 percent of its taxable income to its shareholders. This is exclusive of capital gains.[1] Also, such a corporation can elect to treat as distributed during the year distributions made in the first 2½ months after the end of the year.

(2) designate in written notices mailed to its shareholders their shares of the excess of net long-term capital gains over net short-term capital losses, and the portion, if any, which the corporation has distributed. These notices must be mailed to the shareholders within 45 days after the close of the taxable year.

(3) provide such information as the Treasury Department considers necessary to carry out the purposes of this provision.

[1] For this purpose, as in the case of domestic regulated investment companies, no net operating loss carryover is allowed and no organizational expense deduction is allowed.

In addition to the corporation's fulfilling these requirements, however, the shareholder (who is a U.S. person), if he is to avoid the ordinary income treatment upon the sale of his stock, also must include in his income for tax purposes the excess of the net long-term capital gain over the net short-term capital loss, which the company in its notice to him designated as being his share of the company's capital gains. If the shareholder does not do so for any year, unless this failure was due to reasonable cause and not to willful neglect, the election provided by this provision will not apply when he sells or otherwise disposes of his stock. Thus, although other shareholders might continue to qualify in such a case, the shareholder who did not report this capital gain income, upon his sale of the stock will have ordinary income (limited as indicated above). It is not made a condition of qualification that the shareholder in such a case report his share of the ordinary income of the corporation. However, since at least 90 percent of his share of this income will actually be distributed to him, it must in fact be reported by him, in the same manner as any other dividend income which he may receive from foreign sources.

The bill provides that qualified shareholders are to include in computing their long-term capital gains both the distributed and the undistributed portions of the excess of net long-term capital gains over net short-term capital gains.

The bill further provides that the capital gains, reported by the shareholders, which are not actually distributed, are to result in a decrease in earnings and profits of the corporation for the shareholders who report them and also that the basis that they had for the foreign investment company stock is to be increased by this amount.

The bill also provides that if a foreign investment company has more than 50 percent of the value of its assets invested in securities of foreign corporations and it is registered under the Investment Company Act, it may elect to itself forego any foreign tax credits and instead pass these credits on to its shareholders on a pro rata basis. In such cases the shareholder takes both the dividends and his share of the taxes into his income and then claims a credit against tentative tax for the foreign taxes, subject to the same limitations as if he had paid them directly.

The election to distribute income currently with respect to the foreign investment company continues until the company fails to comply with the three conditions set forth above, unless the company becomes a foreign personal holding company, or no longer is a foreign investment company.

To prevent the use of the capital gains designating provision as a means of obtaining short-term capital losses which may be short-term capital gains or under certain circumstances ordinary income, merely at the cost or reporting a capital gain under this provision, the bill provides that if the shareholder has held the stock for less than 6 months, then any loss realized on the sale of the stock within that 6-month period is to be treated as if it were a long-term rather than short-term capital loss.

3. Effective date.—The amendments made by this provision apply to taxable years beginning after December 31, 1962.

XV. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS

(Sec. 15 of bill and sec. 1248 of code)

A. Reasons for provision

Under existing law, through an ordinary taxable liquidation or sale or exchange, it is possible to bring earnings accumulated by a foreign corporation back to this country merely by paying a capital gains tax on such earnings included in the gain. Theoretically it is also possible to bring earnings accumulated by a foreign corporation back to the United States without payment of income tax through the use of a tax-free reorganization (under sec. 368) or through the use of a tax-free liquidation (under sec. 332). However, to do so the Commissioner of Internal Revenue must give clearance by determining in advance that the transaction "is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes." Generally the Commissioner has been unwilling to grant such approval where there is an appreciable amount of earnings and profits accumulated in a foreign corporation.

The bill has as one of its objectives in the foreign income area the imposition of the full U.S. tax when income earned abroad is repatriated. Full U.S. taxation will occur in the case of the ordinary taxable liquidations or sales or exchanges only if the earnings and profits are in effect taxed as dividends (to the extent of any gain) at the time the funds are brought back to the United States. This objective is accomplished by this section of the bill.

B. Comparison of committee amendments with House provision

Your committee has retained the basic structure of the House bill but has made a number of important modifications in it, which are discussed below.

Under the bill as passed by the House, amounts (to the extent of undistributed earnings) received by an individual or corporate stockholder on the *sale* of the stock (as distinguished from a redemption) were treated as ordinary income and not as dividends. Under your committee's amendments, the appropriate portion of the gain on a sale is also treated as a dividend.

Under the bill as passed by the House, no special treatment was provided for individual shareholders of controlled foreign corporations. They were required to take into their tax base as ordinary income the entire gain in the year recognized. This meant the income might, because of "bunching," be taxed at unusually high rates. Moreover, the individual might be treated much worse than if the corporation had been a domestic corporation subject to the U.S. corporate tax, against which foreign tax credits could be taken, and then the balance distributed and taxed to the individual at capital gains rates. Under your committee's amendments, if the shareholder is an individual his tax (on either a redemption or sale) is to be no greater than that provided under the lower of two ceilings. The first ceiling provides that the individual's tax is to be no greater than if the foreign corporation had been a domestic corporation paying the regular U.S. corporate tax (offset by foreign tax credits allowable to a corporation) which then made a liquidating distribution of the balance to the U.S. share-

holder and this balance was subjected to capital gains tax. In other words, this ceiling would provide a U.S. tax of no more than 52 percent against which foreign tax credits are taken, plus a capital gains tax on the remaining 48 percent at not more than 25 percent. Thus, the aggregate maximum tax could never be more than 64 percent (52 percent plus 25 percent of 48 percent). The second ceiling is an averaging device. It provides that the tax is not to exceed the amount which would have resulted had the earnings and profits been distributed to the shareholder in the years they were earned.

Your committee has also amended the House bill to provide that earnings and profits are not to include profits on sales made during a liquidation if the corporation could have qualified for tax-free sales on liquidation if it had been a domestic corporation.

In addition, your committee has amended the section to provide that it is not to apply to earnings and profits accumulated by a foreign corporation while it was a less developed corporation if the stock sold or exchanged was owned for at least 10 years before the date of sale or exchange by the U.S. shareholder.

Your committee has also amended the House bill to provide that the ordinary income treatment provided by this section is in no case to apply to earnings and profits accumulated in taxable years beginning before January 1, 1963. Under the House bill the ordinary income treatment could apply to earnings and profits accumulated since February 28, 1913.

C. General explanation of provision

The provision as amended by your committee applies to any shareholder who owned 10 percent or more of the total combined voting power of the stock of a foreign corporation at any time during the 5-year period ending on the date of exchange but only if the corporation was a controlled foreign corporation at any time during the period the stock was owned by the shareholder. (The 10-percent ownership is determined under the constructive stock ownership rules in sec. 958(a) as added by this bill.)

The section applies to any sale or exchange or to any surrender of stock to the corporation for redemption in a transaction which would be treated as a sale or exchange under section 302 or section 331 (a buy-out or a total or partial liquidation). If such a sale, exchange or redemption occurs, and there is a gain on the transaction, there is included in the gross income of the person surrendering the stock, as a dividend, the portion of such gain attributable to the earnings and profits of the foreign corporation allocable to the stock surrendered, accumulated while the shareholder held the stock during a period in which the corporation was a controlled foreign corporation, in taxable years beginning after December 31, 1962.

If the shareholder surrendering the stock is a corporation, it is entitled to a credit for foreign taxes paid by the foreign corporation in the same manner and to the same extent as it would be entitled to such credit in the case of any other dividend received from a foreign corporation.

If the shareholder is an individual, the tax to be paid by him shall not be greater than either the "domestic corporation limitation" or the "annual distribution limitation," whichever is the lesser.

The "domestic corporation limitation" is the sum of—

(1) the excess of the U.S. income taxes which would have been paid by the foreign corporation with respect to its income if it had been a domestic corporation over the foreign income taxes actually paid by such corporation, and

(2) the amount of capital gains tax which would have resulted to the shareholder on the surrender of his stock, if the amount actually received by him on such surrender were diminished by the amount described in (1) above.

The "annual distribution limitation" is the amount equal to the aggregate of taxes which would have been attributable to the amount treated as a dividend had it been distributed to the shareholder as a dividend in the year or years in which it was earned.

The earnings and profits for purposes of this section do not include any amount attributable to gains on sales made in the course of a liquidation if these sales would have been treated as tax-free sales on liquidation (under sec. 337(a)) had the foreign corporation been a domestic corporation.

This section does not apply to earnings and profits accumulated by a foreign corporation while it was a less developed country corporation (as defined in sec. 955(c), as added by the bill), if the stock sold or exchanged was owned for at least 10 years by the U.S. persons before the date of the sale or exchange. A transfer of stock by death is viewed as not interrupting the continuous ownership.

This section also provides that any item of gross income of the foreign corporation treated as income derived from sources within the United States is not to be included in the earnings and profits to be taken into account.

This section also contains provisions providing that earnings taxed once under other sections (secs. 951 and 1247) will not be taxed a second time by virtue of this section.

This provision does not apply to distributions to pay death taxes (sec. 303) or to gain realized because of "boot" on a reorganization exchange (sec. 356). It likewise does not apply to any amount which is treated as a dividend, as a gain from the sale of an asset which is not a capital asset, or as a short-term gain under any other section of the code.

This section provides that unless the taxpayer establishes the amount of the earnings and profits of the foreign corporation to be taken into account, the entire gain from the sale or exchange is to be considered a dividend.

This section will apply to sales or exchanges made after December 31, 1962, with regard to earnings and profits accumulated in taxable years beginning after that date.

XVI. SALES AND EXCHANGES OF PATENTS, ETC., TO CERTAIN FOREIGN CORPORATIONS

(Sec. 16 of bill and sec. 1249 of code)

A. Reasons for provision

The House bill in section 13 (now sec. 12 in your committee's amendments) contained a provision which included in the income of 10-percent shareholders of controlled foreign corporations, income of those corporations which arose from patents, copyrights, and exclusive

formulas and processes which have been substantially developed, created, or produced in the United States or acquired from related U.S. persons. The House provision taxed this income to the U.S. shareholders not only when it represented a royalty or similar payment received by the controlled foreign corporation, but also where this corporation itself used the patent, etc. in the manufacture of goods and derived income from the sale of the manufactured articles. In this latter case it would have been necessary to have constructed the income attributable to the patent, etc.

A considerable body of testimony before your committee indicated that it was impractical to attempt to determine this constructive income. Problems also arose, even in the case of royalty payments, in determining how much of the income was due to the patent, copyright, etc., and how much might be due to services rendered in connection with the use of such a patent, etc.

Therefore, your committee has deleted the part of the House provision attributing back to U.S. shareholders income from patents and related rights, and substituted a new provision which merely provides that when a patent, invention, etc., is transferred to a foreign corporation by a U.S. person controlling such corporation, that any gain otherwise recognized is to be ordinary income rather than a capital gain. An exception to this rule is provided where the transfer is to enable the foreign corporation to use the property in its own manufacturing operations. Gain coming under this exception will continue to be treated as capital gain. This amendment applies only in the case of transfers in taxable years beginning after December 31, 1962.

Your committee recognizes that the transfer of U.S. developed patent and similar rights by a U.S. corporation to a controlled foreign corporation causes a diversion of income from U.S. sources. It believes that taxing any gain on such transfer as ordinary income will, however, correct this situation as to such transfers in the future.

B. Comparison of committee amendments with House provision

As indicated above, section 13 of the House bill (sec. 12 under your committee's amendments) would have taxed income attributable to patents, copyrights, and exclusive formulas and processes substantially developed, created or produced in the United States or acquired from related U.S. persons as giving rise to income which, whether distributed or not, was to be taxable to U.S. shareholders of controlled foreign corporations. Your committee has deleted this provision and substituted the new provision which treats gains from the sale of patents, copyrights, etc., as ordinary income rather than capital gain when transferred by a U.S. person to a foreign corporation which it controls.

C. General explanation of provision

Your committee's amendments added a new section to the code providing that gain from the sale or exchange after December 31, 1962, of certain property rights to a foreign corporation by a U.S. person controlling that corporation is to be treated as ordinary income rather than as capital gain. The type of property, the transfer of which will lead to this ordinary income treatment, is—

(1) a patent,
(2) an invention,
(3) a model or design (whether or not patented),

(4) a copyright,
(5) a secret formula or process, or
(6) any other similar property right.

This ordinary income treatment, however, is not to apply in the case of gain realized from the sale or exchange for stock or contribution to capital of such property if it is established to the satisfaction of the Secretary of the Treasury or his delegate that the principal purpose of the transfer was to enable the foreign corporation to use the property in its own manufacturing operations.

For purposes of this provision, a U.S. person will be considered as controlling a foreign corporation if it owns directly or indirectly the stock possessing more than 50 percent of the voting power of all classes of stock entitled to vote. In determining the indirect ownership, certain constructive ownership rules (those in sec. 958) will be applied.

This provision is to apply to taxable years beginning after December 31, 1962.

XVII. TAX TREATMENT OF COOPERATIVES AND PATRONS

(Sec. 17 of the bill and secs. 1381 to 1388 of the code)

A. Reasons for provision

In 1951 Congress passed legislation which, taken together with prior Treasury rulings, it generally was thought insured that earnings of cooperatives would be currently taxable (to the extent they reflected business activity) either to the cooperatives or to the patrons. However, certain court decisions, notably the *Long Poultry Farm* and *B. A. Carpenter* cases, held that noncash allocations of patronage dividends generally were not taxable to the patron, although they were deductible by the cooperative.

The President recommended that what was thought to be the law in 1951 be provided specifically in the statute. Under the recommendation cooperatives would be allowed to deduct amounts allocated in cash or scrip as patronage dividends and patrons would be currently taxable on the patronage dividends allocated to them arising out of business activities.

The House bill adopts an approach which in substance is substantially the same as that recommended by the President. It provides that the cooperative is not required to take patronage dividends paid in money, qualified allocations, or other property, except nonqualified allocations, into account in determining taxable income. A deduction is also provided for the nonqualified allocations when they are redeemed. For the patron, the bill provides that these same amounts (to the extent not attributable to purchases for personal living expenses or capital items) are to be included in income for tax purposes in the year received (or in the case of a nonqualified allocation, when redeemed).

Qualified allocations for this purpose are defined by the House bill as including first, allocations which the patron can redeem in cash at their stated dollar amount at any time in the first 90 days after they are issued and second, qualified allocations which the patron has consented to take into account at their face amount as income (unless the patronage was with respect to personal living expenses or capital

items). In the case of members, consent may be given by being a member of the cooperative if there is a provision in the bylaws requiring all members to agree to take the allocations into account. In the case of nonmembers (and members if the cooperative prefers) this consent can be provided by the patron signing an agreement to do so. (As explained subsequently your committee also provides another manner of obtaining the consent of the patrons.) Your committee agrees with the House that, since in the case of either the 90-day or consent allocation the patrons have constructively received the dividend and reinvested it, it should constitute income to the patron (where the patronage dividend arises from business activity) and should be taxable to him.

The House provision is effective for taxable years beginning after December 31, 1962, in the case of the cooperatives and in the case of patrons is effective with respect to amounts paid by the cooperatives in taxable years of the cooperative beginning after that date. Existing law will continue to apply with respect to allocations (including their redemption after the specified date) issued with respect to patronage in earlier taxable years to which the new provisions do not apply.

B. Comparison of committee amendments with House provision

Your committee has accepted the tax treatment outlined in the House bill for cooperatives and their patrons with two modifications. First, it is provided that at least 20 percent of patronage dividends must be paid in cash for the cooperative to receive any deduction with respect to their patronage dividends. Likewise, a 20-percent cash payment must be made for exempt cooperatives to receive a deduction for distributions out of nonpatronage earnings. Second, a new form of consent is provided, namely, the qualified check, which the cooperative may use.

The House bill provided for withholding on interest, dividends, and patronage dividends at the rate of 20 percent. Your committee's bill has substituted for the withholding provision a reporting system for dividends, interest, and patronage dividends. However, in the case of patronage dividends, withholding also served the purpose of providing the patron with at least enough funds to pay the full first bracket tax on any qualified allocations taxable to him. Your committee believes that it would be unfortunate to require the patrons to report these qualified allocations for tax purposes without being sure that the cooperative made available to the patrons enough cash to pay at least the first bracket income tax. To give assurance that the cooperative provides the patron with at least enough money to pay this first bracket tax, your committee has provided that cooperatives must pay at least 20 percent of their patronage dividends (and in the case of tax-exempt cooperatives other income distributed on a patronage basis) in cash if the cooperatives are to receive any deductions for allocations (and the patrons are to be required to include any such amounts in their income).

Under the House bill a patron could give his consent to being taxed on a noncash patronage dividend (as having been constructively paid to him and then reinvested) either by providing such consent in writing, or by being a member of the cooperative during the period in which its bylaws provided that membership constituted such consent. Your committee, in addition to these two procedures, has provided

that consent may also be supplied by endorsing and cashing a qualified check. The check must indicate, however, that by endorsing and cashing it the patron is consenting to taking the remainder of the patronage dividend into account in computing his taxable income. This may be a convenient way of obtaining consent for some cooperatives, particularly from nonmembers, who it may be difficult for the cooperative to contact directly. For a cooperative to omit a patronage dividend under this procedure in computing its taxable income for the year the patronage occurs, the qualified check must be endorsed and cashed within 90 days after the end of the payment period for the cooperative, namely, within 90 days after 8½ months after the close of the cooperative's taxable year. A qualified check endorsed and cashed after that time will be deductible by the cooperative when the endorsing and cashing occurs, as a redemption at that time of a nonqualified allocation.

C. General explanation of provision

This provision deals both with the tax treatment of cooperatives and the tax treatment of patrons.

1. *Cooperatives covered by provision.*—The tax treatment outlined here applies to the so-called tax-exempt farmers' cooperatives, to other farm cooperatives, to consumer cooperatives, and also to other corporations operating on a cooperative basis. The provision does not, however, apply to exempt mutual ditch, irrigation, or REA cooperatives, to mutual savings banks, building and loan associations, etc., or to mutual insurance companies. It also does not apply to presently taxable organizations which are engaged in furnishing electric energy, or providing telephone service, to persons in rural areas. These will continue to be treated the same as under present law.

2. *Patronage dividends.*—The bill provides that in determining the taxable income of a cooperative there is not to be taken into account patronage dividends which are paid in money, qualified allocations, or other property (except nonqualified allocations).[1] A deduction also is allowed for nonqualified allocations when they are redeemed in cash or other property (except allocations). If there is no taxable income in the year of the redemption against which to take this deduction for redeemed nonqualified allocations, the cooperative may obtain a credit or refund of the tax it paid in the prior year on the earnings represented by the allocations. This gives the cooperative assurance that the deduction for the redeemed patronage dividend will not be wasted.

Under present law patronage dividends paid by taxable cooperatives result in a reduction in the cooperative's taxable income only if they are paid during the taxable year in which the patronage occurred, or within the period in the next year elapsing before the prior year's income tax return is required to be filed (including any extensions of time granted). This is generally a 2½-month period. In the case of exempt farmers' cooperatives, these patronage dividends presently are taken into account as a reduction in taxable income if paid at any time before the 15th day of the 9th month following the close of the year, but there is no requirement that the patronage must have occurred in that year. The bill extends the time period in

[1] For purposes of the internal revenue laws these patronage dividends are treated in the same manner as items of gross income for which deductions were allowed.

which taxable cooperatives can pay patronage dividends, and still take them into account in reducing taxable income, until this 15th day of the 9th month after the end of the year in question. This conforms the treatment to that already accorded exempt cooperatives. This period of time is also made available to both "taxable" and "exempt" cooperatives for payment of the other deductible amounts described below. In addition, exempt cooperatives are now required to pay the patronage dividends within 8½ months after the year when the patronage occurred. In the case of pooling arrangements extending over more than 1 year, the patronage is considered as occurring in the year in which the pool closes.

3. *Qualified allocation.*—Allocations, or more exactly written notices of allocation, must be in the form of capital stock, revolving fund certificates, certificates of indebtedness, or other written notice which indicates to the recipient the dollar amount allocated to him by the cooperative. For the allocation to be a qualified allocation, 20 percent of the patronage dividend involved must be paid in money (or in a "qualified check" referred to below).[2] In addition, for the allocation to be qualified one of two other conditions must be met. The patron must either have the opportunity to take down the allocation in cash for a limited period of time, or, in one of three specified forms, must have given his consent to having the allocation treated as constructively distributed to him and reinvested by him in the cooperative. With respect to the first of these requirements, the bill provides that the patron must be able to convert the allocation into cash at any time during at least the first 90 days after the allocation is made. In addition, the patron must receive a written notice of the right of redemption at the same time he is notified of the allocation.

In lieu of the right to convert an allocation into cash, an allocation may be qualified where the patron gives his consent to have it treated as a distribution made to him which he agrees to take into his income for tax purposes (if the patronage arises from business activity). Under your committee's amendments this consent may take any one of three forms. For members of the cooperative this consent may be given merely by becoming, or continuing, as a member after the cooperative has adopted (after the enactment of this bill) a provision in its bylaws providing that membership in the cooperative constitutes such consent. In this case, however, the member (or prospective member) must be furnished with a written notice that the bylaws contain such a provision and must be furnished a copy of this provision. Such a consent cannot be revoked as long as the patron is a member.

A second form of consent, which may be used either for members of the cooperative, nonmembers or both, is a written statement signed by the patron in which he gives the consent referred to above. This form of consent must originally be given by the patron to the cooperative before the end of the year in which the patronage occurs and applies to all patronage in that year and subsequent taxable years until the consent is revoked. A revocation of this consent must be in writing and can be made at any time but becomes effective only for the first of the next year.[3]

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[2] The 20-percent cash payment is also required in the case of exempt cooperatives for amounts paid on a patronage basis with respect to earnings derived from business done for the United States (or any of its agencies) or from sources other than patronage.

[3] In the case of pooling arrangements, a revocation is effective only with respect to new pools.

A third form of consent, provided by your committee's amendments involves the use of a qualified check. This may apply either to members, nonmembers, or both, but applies only if neither of the other two forms of consent had been obtained with respect to a patron. Under this form of consent the cooperative gives the patron a check representing a portion of the patronage dividend.[4] This check (which also includes a similar instrument redeemable in money) must have clearly imprinted on it a statement that its endorsement and cashing constitutes consent of the patron to include the full stated dollar amount of the allocation, referred to in the check, in his income, to the extent provided by the Federal tax laws. To treat the noncash allocation accompanying the qualified check as a qualified allocation, the check itself must be cashed not later than 90 days after the payment date of the cooperative for patronage dividends (that is, 90 days after September 15 in the case of a calendar year cooperative). This is not intended to deny the cooperative the right, however, to issue the qualified checks substantially before the payment date and require cashing within a 90-day period thereafter. In this manner, if the cooperative wants to, it may require any cashing of the checks before its payment date.

By any of the three forms of consent described above the patron has in effect acknowledged constructive receipt of the entire amount of the patronage dividend and has voluntarily reinvested the amount of the allocation in the cooperative.

If an allocation is not a qualified allocation because one of the conditions set forth above has not been met, it must be included in the income of the cooperative in the year issued, with a deduction being taken for this amount by the cooperative only when the nonqualified allocation is finally redeemed in cash or merchandise. If at that time the cooperative is not able to make use of a deduction, a refund may be obtained with respect to the taxes paid on this amount in the year the allocation was issued.

4. Additional deduction for "exempt" farmers' cooperative.—In addition to reducing taxable income for qualifying patronage dividends, the bill, permits the so-called exempt farmers' cooperative, as under present law a deduction for amounts paid out as dividends on its capital stock. Such cooperatives also receive deductions for amounts paid in money, qualified allocations, or other property (except nonqualified allocations) to their patrons on a patronage basis where the earnings involved are derived from business done for or with the U.S. Government or from sources other than patronage (such as investment income).

This deduction is the same as that provided by existing law except that the deduction is limited to qualified allocations and must be paid within 8½ months after the year in which the earnings were *derived.* Amounts paid in the redemption of nonqualified allocations also are available to these exempt cooperatives as deductions under the bill in the year of the redemption.

5. Treatment of patron.—With the exceptions referred to below, under the bill the patron is required to take into income the patronage dividends (and the nonpatronage distributions described above) paid

[4] The check may also be used as part of a distribution of any amounts paid on a patronage basis with respect to earnings derived from business done with the United States (or any of its agencies) or from sources other than patronage.

in money, qualified allocations, or other property, and the amount he is required to take into his income is the same as that which may be currently deductible or excluded by the cooperative; namely, in the case of qualified allocations, there stated face amount, and in the case of other property (except nonqualified allocations) its fair market value. The patron also is required to take into income any nonqualified allocations which are redeemed. These amounts are taken into the patron's income in the year in which they are received by him, or in the latter case in the year in which the redemption occurs.

Generally, the effect of the treatment specified above for patrons taken together with that also outlined above for cooperatives is to obtain a single current tax with respect to the income of the cooperative, either at the level of the cooperative or at the level of the patron. However, this rule will not apply in the case of patronage dividends paid with respect to purchases of personal, living, or family items. with respect to the patronage dividends even though they are not In such cases there is to be no inclusion in the income of the patron taken into account by the cooperative. This is in accord with the concept that patronage dividends represent price adjustments. Therefore, the patronage dividends in these cases represent downward price adjustments of personal, living, or family items and should no more lead to taxable income than bargain purchases of such items elsewhere.

An exception to the rule for inclusion of the patronage dividends in income is also made for patronage dividends attributable to purchases of depreciable property or capital assets. In such cases the patron is not required to take the dividend into income since it in effect represents an adjustment in the price paid for these articles and therefore is reflected in their basis. However, the lower basis for the property in the case of depreciable property will mean smaller depreciation deductions or in the case of capital assets (and depreciable assets) will result in a larger gain upon sale.

6. *Returns of cooperatives.*—Because tax-exempt cooperatives under present law are given until 8½ months after the end of the year to allocate, or pay, patronage dividends, they also have been given the same period of time in which to file their tax returns. This additional time is necessary since whether or not there is an allocation or payment of the dividends, determines the size of the taxable income of the cooperative.

Allowing taxable cooperatives this same time in which to make cash and qualified allocations of patronage dividend distributions, and to redeem nonqualified allocations, has presented the same filing problem in the case of their returns as well. Therefore, the bill provides that the tax return filing date for cooperatives generally is to be 8½ months after the end of their taxable year. However, to prevent an organization allocating relatively little of its income on a patronage basis from obtaining this postponement in the filing date for its return, the bill limits this postponement to those organizations which are either exempt cooperatives or (1) are under an obligation to allocate, or pay, at least 50 percent of their net patronage earnings in patronage dividends or (2) actually allocated, or paid, at least that percentage of their earnings in patronage dividends during the last year in which they had any such earnings.

7. *Effective date.*—Generally, the bill applies to taxable years of the cooperatives beginning after December 31, 1962. For the patrons

these provisions are to apply with respect to amounts paid by the cooperative during a taxable year which, at the cooperative level, is also subject to the new rules. Existing law continues to apply with respect to patronage dividends paid before the date specified above (or after that date with respect to patronage in a prior year) and also with respect to redemptions of patronage dividends after that date if the scrip involved was actually issued with respect to an earlier period.

XVIII. INCLUSION OF FOREIGN REAL PROPERTY IN BASE FOR ESTATE TAX PURPOSES

(Sec. 18 of bill and secs. 2031, 2033–2038, 2040 and 2041 of the code)

A. Reasons for provision

Under present law real estate situated outside of the United States is excluded from the gross estate and therefore exempt from the estate tax. This is an exception to the general rule that the gross estate of decedents who are citizens or residents of the United States include their entire property wherever situated. The exclusion of real property located outside of the United States from the estate tax base has been specifically provided for in the code since 1934. Before that time the exclusion was granted under an opinion of the Attorney General issued in 1918.

In 1951 Congress adopted legislation providing a credit for estate and inheritance taxes paid to foreign countries. Before that time the exclusion of real property from the estate tax base could be justified on the grounds that the foreign country was likely to impose a tax on real property located within its jurisdiction upon the death of a foreign owner. However, with the provision for the tax credit in 1951, the possibility of double taxation was removed.

The President in his tax program recommended that this exemption be eliminated on the grounds that in recent years this has been a subject of abuse. It was stated that primarily because of this tax advantage, U.S. citizens and residents have been induced to make investments in foreign real estate in countries with either no, or very low, estate or inheritance tax rates.

In view of these considerations the House bill requires the inclusion of real property located outside of the United States in the estate tax base.

B. Comparison of committee amendments with House provision

Your committee has made no change in the House provision other than to advance by 1½ years the effective date of the provision. Thus, under your committee's action the provision will generally become effective for decedents dying on or after January 1, 1963, rather than July 1, 1964. As under the House bill the provision becomes effective for decedents dying after the date of enactment of the bill in the case of property acquired on or after February 1, 1962.

C. General explanation of provision

Under present law, real property situated outside the United States is excluded in determining the value of a decedent's gross estate for estate tax purposes. This section of the bill amends various sections of the code specifically to include such real property in the gross estate of decedents who are citizens or residents of the United States. The

property is included at its fair market value either at the date of death or at the optional valuation date.

In the case of decedents dying after January 1, 1963, the bill provides that all real property located outside of the United States is to be included in the gross estate. However, some real property may also be included in a decedent's gross estate under the bill in the case of those who die after the date of enactment of the bill but before January 1, 1963. For decedents dying in this period, real property located outside of the United States is to be included in the gross estate if it was acquired on or after February 1, 1962, the date the House Committee on Ways and Means announced its action on this provision.

Capital additions or improvements to real property, to the extent they materially increase the value of the property and to the extent they are attributable to construction, reconstruction or erection on or after February 1, 1962, are treated in the same manner as real property acquired after that date. Thus, they are included in the gross estates of decedents dying after the date of enactment of the bill.

XIX. REPORTING OF INTEREST, DIVIDENDS AND PATRONAGE DIVIDENDS OF $10 OR MORE A YEAR

(Sec. 19 of the bill and secs. 6042, 6044, 6048, 6652 and 6678 of the code)

A. Reasons for provision

The House bill would have provided a 20-percent withholding tax applicable to most interest, dividend and patronage dividend payments. In recognition of the hardship that a universal withholding system would provide, the House bill provided for an annual exemption certificate system for individuals expecting to have no tax liability. In addition, it provided for quarterly refunds of overwithholding to be made to individuals expecting to have tax liability, but with incomes of less than $5,000 in the case of single persons or $10,000 in the case of married couples. The refunds in this case were intended to be made on a quarterly basis during the year in which the withholding occurred in order to relieve the hardship with respect to the individuals being overwithheld upon. In addition, under certain circumstances, exemption certificates, intra-annual refunds and credits and offsets would have been available under the House bill in the case of governments, tax-exempt organizations, or corporations.

Your committee has studied at length the system provided by the House bill for withholding on dividends, interest, and patronage dividends. In addition, it has considered numerous alternative withholding provisions. It is convinced after this analysis, however, that the provision in the House bill, as well as the alternatives, are neither simple in operation nor free of substantial hardship for broad groups of taxpayers. Furthermore, it represents a heavy administrative burden for the businesses which would have to perform the withholding and collecting functions for the Government. It also appears that there are numerous tax avoidance possibilities in a system providing exemption certificates and intra-annual refunds. The exemption certificate procedure under the House bill was available only to those who expected to have no tax liability whatsoever (unless the persons involved were under age 18). Thus, many individuals, who

could expect to have a small tax liability, but be faced with substantial overwithholding on dividends and interest, would receive no relief under this exemption certificate system. Such individuals instead would have had to rely upon the quarterly refund system to recoup their overwithholding. Those who filed these claims could expect a delay of at least 3 or 4 weeks and perhaps as much as 3 or 4 months before the withheld amounts were returned. This would deprive them of the use of these funds for living expenses or as sources of investment during the interval. Moreover, the quarterly refund claims which would have had to be made four times a year involved a complex procedure.

While the exemption certificate and quarterly refund procedures of the House bill did not resolve the hardship problems for the shareholder or depositor, they nevertheless presented many compliance problems for the corporate and bank payors of the dividends and interest. Especially difficult from their standpoint would be the processing of the exemption certificates, which not only must be filed each year but also might be subject to change during the year as the individual's expectations with respect to his prospect of having a tax liability changed.

In addition, the House bill would have presented serious administrative problems for the Internal Revenue Service. The use of the exemption certificates, for example, in practice might not have been limited to those who "reasonably expect no tax liability." Moreover, since the individual, when he filed his quarterly refund claim, need submit no proof of the receipt of dividend or interest payments, here also there would seem to be a chance of fraud as well as unintentional mistakes. Nor is it clear that the ordinary recipients of dividends and interest would understand the so-called "gross-up" system which the House bill required them to follow in reporting dividends and most interest on their tax returns.

Despite the shortcomings of a system for withholding on dividends, interest, and patronage dividends, your committee strongly endorses the concept that everyone must pay his full share of the income tax liability. Moreover, it recognizes that the underreporting of dividends and interest on tax returns is a serious problem which needs correction. However, it has concluded that an improved reporting system is preferable to provision for withholding.

Your committee believes that the matching of information returns and tax returns by the Government can provide essentially the same check on dividend and interest reporting as a withholding system, except that the effectiveness of the information returns is not limited to collecting the tax at the first bracket rate. While it may be difficult initially to provide a full matching of information and tax returns, the extended use of automatic data processing, together with the accounting number system provided for in legislation enacted last year, should quite soon make it possible to provide for a full matching of these information and tax returns.

It is recognized that improving the collection of tax with respect to dividend, interest, and patronage dividend payments by an expanded use of information returns may involve some increase in the personnel of the Internal Revenue Service. It is believed, however, that this is preferable to the complications and hardships which would be involved under a withholding system.

As a result, your committee, in lieu of the withholding provisions of the House bill, provides that payors of dividends, interest, and patronage dividends are to report annually to the Federal Government all such payments aggregating $10 or more per person. In addition, they are to send the recipients of these dividends, interest payments, or patronage dividends an annual statement indicating the total of such payments.

B. Comparison of committee amendments with House provision

As indicated above, the House bill made provision for withholding at a rate of 20 percent with respect to most interest, dividend, and patronage dividend payments. In this system provision was made for the use of exemption certificates for individuals expecting to have no tax liability and a system of quarterly refunds for those having a tax liability but subject to overwithholding. Your committee's amendments in lieu of this provide for the submission by payors of information returns to the Government for interest, dividends, and patronage dividends of $10 or more per person per year. Essentially the same information must also be submitted by these payors to the recipients of interest, dividends, or patronage dividends. The reporting system provided is described more fully below.

C. General explanation of provision

1. *Reporting requirements.*—The bill provides that dividend, interest or patronage dividend payors who make payments during the year aggregating $10 or more to any person are to file annual returns with the Internal Revenue Service reporting such payments. (The term "payments" is intended to include not only actual payments in cash or its equivalent but also credits to the account of the payee which he may withdraw at any time without restriction.) The return must show the aggregate amount of the payments to the person involved and give the name and address of the person to whom the payments are made. The bill also provides that nominees, who receive payments of dividends or interest and make payments of $10 or more to other persons, also are to make a return to the Government with respect to annual payments of $10 or more per person. This category includes such payments as those made by stockbrokers to individuals where the stock is registered in the street name of the broker. In the case of patronage dividends, only cooperatives to which the new provisions of this bill apply (sec. 17) must file these returns with respect to patronage dividends.

Existing law in the case of dividend payments provides for the submission of information returns by every cooperation "when required by the Secretary or his delegate." Under regulations (sec. 1.6042–1) the Treasury Department has required information return reporting by those making dividend payments during the calendar year of $10 or more. In the case of interest payments, present law requires the submission of information returns with respect to payments of $600 or more, as is true in the case of numerous other types of payments made in the course of a trade or business. In addition, present law provides that payments of interest by corporations, regardless of amount, "when required by regulations of the Secretary or his delegate" must be reported to the Internal Revenue Service. In the case of interest, however, the Secretary has not by regulations provided for reporting with respect to payments of less than $600. In the case of

patronage dividends, present law requires reporting to the Internal Revenue Service with respect to amounts of $100 or more. It also authorizes the Secretary to require reporting with respect to lesser amounts. The Secretary has not, however, exercised this authority.

Your committee's amendments, in addition to making mandatory the reporting of dividends, interest, and patronage dividends of more than $10 per year per person, also continue the provisions of present law permitting the Secretary at his discretion to require reporting with respect to smaller amounts.

In addition to the reporting to the Internal Revenue Service, your committee's amendments also require that annual statements be submitted to all recipients of dividend, interest, and patronage dividend payments of more than $10 a year. These statements must show the amount of the payment reported to the Government and the name and address of the payor. No such statements are required, however, to be furnished to any person if the aggregate of these dividend, interest, or patronage dividend payments is less than $10 a year.

2. Penalty provisions.—Your committee, in the interest of being sure that the information returns are supplied the Government, and also that the statements are submitted to the dividend, interest, or patronage dividend recipients, has provided civil penalties which apply in the case of noncompliance.

These new penalties apply with respect to the failure to supply the information statements to those receiving $10 or more a year and also to failures to supply information returns to the Internal Revenue Service with respect to dividend, interest, and patronage dividend payments of $10 or more a year per person. The penalty provided in these cases, for failing to provide either a statement to the recipient, or an information return to the Government, with respect to each person to whom $10 or more a year was paid, is $10 for each statement or return not so filed, but not to exceed $25,000 for failures to file returns with the Government and $25,000 for failures to submit statements to payees, with respect to the payor in any calendar year.

Existing penalties (in general $1 per statement but not more than $1,000 per payor) will continue to apply with respect to the reporting which the Secretary of the Treasury may require "for payments aggregating less than $10 a year."

3. Definitions.—In defining dividend, interest, and patronage dividend payments subject to the reporting requirements your committee has followed quite closely the definitions contained in the House bill for purposes of withholding.

Dividends are defined as distributions by a corporation which, for purposes of the Internal Revenue Code, generally are classified as a dividend. The definition of dividends for this purpose also includes payments made by stockbrokers to any person as a substitute for a dividend. This is primarily concerned with payments made by brokers to persons whose stock has been borrowed to cover short sales but who are due "dividend" payments.

Excluded from the definition of dividends for purposes of these reporting requirements are: (1) to the extent provided by regulations, any distribution or payment by a foreign corporation or to a foreign corporation, nonresident alien, or foreign partnership; and (2) undistributed taxable income of small business corporations electing to

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have their income taxed to their shareholders. In any case where a payor is unable to determine whether a payment is a dividend, he is to include the entire amount as a dividend for reporting purposes.

Interest for purposes of the reporting requirements is defined as—

(1) interest on evidences of indebtedness (such as bonds, debentures, notes, and certificates) issued by a corporation in registered form. In addition, to the extent provided in regulations, interest on other evidences of indebtedness issued by a corporation of a type offered by corporations to the public;

(2) interest on bank accounts;

(3) interest, or other amounts, paid by mutual savings banks, savings and loan associations, or similar organizations with respect to deposits or similar funds left with such institutions;

(4) interest on amounts held by insurance companies under an agreement to pay interest; and

(5) interest on deposits with stockbrokers and dealers in securities.

For reporting purposes the term "interest" does not include (1) interest on tax-exempt State and local government obligations, (2) to the extent provided by regulations, interest paid by or to foreign corporations, nonresident aliens, or foreign partnerships, and (3) interest on tax-free covenant bonds. These categories for which reporting in the case of interest payments is required to include practically no interest payments by individuals.

In the case of patronage dividends, reporting is to apply to patronage dividends paid in money, qualified allocations or other property except nonqualified allocations, amounts paid by tax-exempt cooperatives with respect to earnings from business done with the U.S. Government or attributable to other than patronage and nonqualified allocations which are redeemed.

The exceptions where the reporting does not apply in the case of patronage dividends include, to the extent provided by regulations, payments made by a foreign corporation, to a foreign corporation, to a nonresident alien or to a foreign partnership. In addition if a cooperative applies to the Secretary or his delegate for exemption from the reporting requirement on the grounds that the cooperative is primarily engaged in selling at retail goods or services of a type generally for personal, living or family use, and the Secretary determines this is true, no reporting shall be required with respect to such cooperative.

4. Inspection of books.—Present law (sec. 7605(b)) provides certain procedures which must be followed if the Internal Revenue Service needs to make an additional inspection of a taxpayer's books of account after it has once done so. Under this section, the Secretary or his delegate may not make an additional inspection before (1) an investigation which shows necessity for the additional inspection and (2) notification of the taxpayer in writing that the inspection is necessary. At present there are relatively few cases where it is necessary for the Service to reopen a taxpayer's return which has been audited. However, with the expanded information reporting provided by your committee, it is expected that the Service will follow up discrepancies each year with respect to many taxpayers. There are difficulties in coordinating these inquiries as to discrepancies disclosed by informa-

tion returns with general audits of tax returns selected for examination. Such inquiries will be made as a routine follow-up of machine operations, and in most instances will be carried out independently of regular audit procedures.

Your committee wishes to make it clear that an Internal Revenue Service contact with a taxpayer solely for the purpose of verifying the correct amount of interest, dividends, and patronage dividends to be reported in cases of discrepancy between information returns and a tax return should not be considered as an inspection of a taxpayer's books of account (within the meaning of sec. 7605(b)). Thus, such an inquiry will not require an investigation and notification to the taxpayer in cases in which a prior audit has been conducted, nor will a subsequent audit require the investigation and notification merely because there has previously been an inquiry limited to determining the correct reporting by the taxpayer of items of gross income subject to reporting on information returns by the payors thereof.

XX. INFORMATION WITH RESPECT TO FOREIGN ORGANIZATIONS

(Sec. 20 of the bill and secs. 6038, 6046, and 6678 of the code)

A. Reasons for provision

The administration has asked for the right to obtain more information with respect to operations of Americans abroad. First, with respect to the annual information return, now required of domestic corporations controlling foreign corporations, it was requested that this return also be required of individual citizens or residents of the United States controlling foreign corporations. Second, in addition to the various specified types of information now required to be submitted, it was also requested that the Treasury Department be permitted to require the furnishing of other information which is similar or related in nature to that specified in the existing provision. Third, existing law requires the supplying of this information with respect to a foreign subsidiary, or a subsidiary of such a subsidiary. It was desired that this information also be required of any other controlled foreign corporation. Fourth, it was requested that the definition of "control" be broadened to include most of the constructive ownership rules generally applied elsewhere in the code.

The administration also requested that the information return now required of officers, directors, and significant shareholders of foreign corporations upon the creation, organization, or reorganization of such corporations also be required of persons who are now, or when they become, officers, directors, or important shareholders.

In addition, the administration requested that a civil penalty be provided for those failing to file the returns as to organization, reorganization, etc., of foreign corporations. The penalty in this case is to be $1,000 unless it can be shown that the failure is due to reasonable cause.

The House bill provided for the submission of this additional information.

B. Comparison of committee amendments with House provision

Your committee has accepted the House provision for expansion of the information to be required with respect to foreign organizations, with four modifications. Two of these relate to the annual information return. First, with respect to the annual information return it has provided a "ceiling" on the penalty which may be imposed in those cases where this information is not supplied. The penalty under present law in general terms provides that failure to supply the required information will result in a decrease of 10 percent in the foreign tax credit allowed to a domestic corporation, plus an additional 5 percent for each additional 3-month period during which the failure to furnish the information continues. Your committee's amendments provide that in no event shall this penalty exceed $10,000 or the income of the foreign corporation with respect to which the failure occurred, whichever is the greater. Second, in the case of the annual information return, in determining whether or not 50-percent control exists, your committee has narrowed somewhat the constructive ownership rules applied under the House bill.

In the case of the information required with respect to organizations, reorganizations, etc., your committee also has made two amendments. First, it provided that officers or directors who are U.S. citizens need supply information only if there are 5-percent U.S. shareholders, and that the information they submit be only the names and addresses of such shareholders. Second, it has added a provision that no information is to be required to be furnished with respect to a foreign corporation unless that information was required under regulations in effect 90 days prior (30 days prior at the beginning of the first year) to the date on which the U.S. persons become liable to file the return with respect to the information.

C. General explanation of provision

1. Annual information return.—In 1960 Congress enacted legislation (Public Law 86–780) providing that domestic corporations must furnish with respect to foreign corporations which they control and also with respect to foreign subsidiaries of any such foreign corporations information specifying—

(1) The name, place, and nature of business of the foreign corporation and country of incorporation;

(2) The accumulated profits of the foreign corporation or subsidiary, including items of income, deduction, and other items taken into account in computing these accumulated profits;

(3) A balance sheet of the foreign corporation or foreign subsidiary;

(4) Transactions between the foreign corporation or foreign subsidiary and (*a*) other foreign corporations or foreign subsidiaries controlled by the domestic corporation, (*b*) the domestic corporation or (*c*) any shareholder owning at least 10 percent of the stock of the domestic corporation; and

(5) A description of the various classes of stock outstanding and name and address and number of shares held by each citizen or resident of the United States and domestic corporation holding 5 percent or more of the stock of the foreign corporation or foreign subsidiary.

Corporations failing to supply any of the information required on the due date receive a 10-percent reduction in their foreign tax credit otherwise available with respect to the income derived from all the foreign corporations or their subsidiaries. If the failure to supply the information continues for more than 90 days, after notification of this failure, then for each 3 months of additional time (or fraction) the reduction in the credit is increased by 5 percent.

The House bill amends this information provision in several respects. First, it requires U.S. citizens or residents, domestic partnerships and domestic estates or trusts as well as domestic corporations controlling the foreign corporations to supply the information specified. Second, "control" is redefined by adding most of the constructive ownership rules of the existing section 318(a). Third, the House bill also extends somewhat the type of foreign corporation with respect to which information must be supplied. Existing law applied to foreign corporations controlled by Americans and subsidiaries which they control. In other words, it applies to two levels of ownership of foreign corporations. The bill extends the requirement to apply to any number of levels of ownership so long as there is control of the corporations involved. Fourth, in addition to the listed types of information, the Treasury Department may also require the furnishing of any other information which is similar or related in nature to that specified.

Your committee has accepted the House amendments with a modification of the constructive ownership rules referred to above and with the addition of a "ceiling" on the penalty provided by present law for the failure to supply the information required. In the case of the constructive ownership rules it has provided that stock owned by a partner, an estate, a trust, or a corporation will not be treated as being owned by the partnership, estate, trust or corporation if this treats a U.S. person as owning stock owned by a person who actually is not a U.S. person. Your committee's amendments also provide that a person is not to be considered as owning his pro rata share of stock held by a corporation if his stock interest is not more than 10 percent.

As indicated above, if a domestic corporation fails to supply information with respect to a subsidiary, it may lose anywhere from 10 to 100 percent of its foreign tax credit, even though only a small proportion, or none, of this credit may be attributable to the subsidiary with respect to which the information is not supplied. Your committee's amendments limit the credit which may be denied in such a case to $10,000 or the amount of income of the foreign subsidiary with respect to which the failure occurs, whichever is the greater.

2. Information with respect to organization, reorganization, etc.—Present law also requires U.S. citizens or residents who are officers or directors of a foreign corporation within 60 days of its creation, organization or reorganization, and also U.S. persons who within the same 60-day period own 5 percent or more of the value of the stock of the corporation, to supply information with respect to this corporation. The return is required to contain such information as the Secretary of the Treasury or his delegate prescribes by forms or regulation as necessary to carry out the provisions of the income tax laws.

Under existing law it is possible to avoid this information requirement where the U.S. citizen or resident first becomes an officer, direc-

tor, or owner of 5 percent or more of the value of the stock of the corporation after the 60-day period. To prevent this avoidance of the information requirement the bill extends the requirement for supplying the information so that it applies to those U.S. citizens or residents who are officers, directors, or shareholders with more than a 5-percent interest on January 1, 1963, or who acquire such positions after that date. This information also is to be supplied by shareholders whose holdings after that date are increased to 5 percent (or where they acquire an additional 5 percent of the stock of the corporation). This reporting requirement in the case of U.S. citizens or residents who are officers or directors, however, under your committee's amendments applies only if there is a U.S. person who holds 5 percent or more of the stock of the corporation. Moreover, only the names and addresses of the 5-percent shareholders who are U.S. persons are required to be reported.

Your committee has also added an amendment to provide that no information is to be required of a foreign corporation unless that information was required under regulations in effect 90 days (30 days at the beginning of first year) prior to the time the liability to file a return under this provision arises.

The bill also adds a new section to the code providing a civil penalty in the case of any person required to file the return referred to here who fails to do so at the time required, or who files a return which does not show the information required. The penalty in this case is to be $1,000 unless it is shown that the failure is due to reasonable cause.

3. Effective dates.—The amendments with respect to the annual information return apply with respect to annual accounting periods of the foreign corporations beginning after December 31, 1962. The amendments relating to the filing of returns as to organization, reorganization, etc., of foreign corporations takes effect on January 1, 1963.

XXI. CLEARING OF LAND

(Sec. 21 of the bill and sec. 182 of the code)

A. Reasons for provision

Under existing law expenses incurred in carrying on a trade or business of farming are deductible in determining taxable income. In 1954 Congress amended the statute to include in the deductible category expenses for soil and water conservation.

This new provision deals with a problem quite similar to that which resulted in the enactment of the soil and water conservation provision. At the present time, expenditures made during the preparatory period in extending a farm may not be deducted since they are not expenses incurred in the business of farming. Examples of expenditures of this nature which, under existing law, must be capitalized are expenditures (including material and labor) incurred in: (1) Clearing brush, trees, and stumps, (2) leveling and conditioning land, and (3) straightening creek beds. Because expenditures for these purposes, when incurred in order to make the land suitable for farming (like expenses for soil conservation), also are closely associated with the trade or business of farming, your committee believes that it would be proper to allow their deduction to a limited extent.

B. Comparison of committee amendment with House provision

There was no comparable provision in the House bill.

C. General explanation of provision

This provision permits taxpayers engaged in the business of farming to deduct, in computing their Federal income tax, expenditures incurred by them in clearing land to make it suitable for farming. Activities included in clearing and preparing land to make it suitable for farming include the clearing of brush, trees, stumps, and boulders, the leveling and conditioning of the land, and the diversion of streams.

Under the bill, deduction of expenditures in any taxable year for these purposes may not exceed $5,000, or, if lesser, 25 percent of the taxpayer's taxable income from farming. In determining the amount which may be deducted within these limitations, the farmer is permitted to include a reasonable allowance for depreciation with respect to tractors and other items subject to the allowance for depreciation which are ordinarily used by him in his farming activities but which actually may have been used also in the clearing of land.

This provision is to apply for taxable years beginning after December 31, 1962.

XXII. CHARITABLE CONTRIBUTIONS MADE FROM INCOME ATTRIBUTABLE TO SEVERAL TAXABLE YEARS

(Sec. 22 of the bill and sec. 1307 of code)

A. Reasons for provision

In the case of individuals who receive compensation in 1 year for services performed over a period of more than 3 years, or who receive a lump sum of income from an invention or artistic work (or from certain other specified sources) present law provides that the tax on this income is not to be greater than the tax which would have resulted if the bunched income had been received ratably over the period to which it is attributable. The effect of this is to permit income to be averaged for tax purposes in the specified situations.

In applying this provision, the Internal Revenue Service has ruled that deductions based upon adjusted gross income (such as charitable contributions and medical expenses) must be recomputed each time a different amount is taken to represent adjusted gross income in determining tax under the averaging provisions (IR–Mim. 43, 1952–2CB 112). It has come to the attention of your committee that because of this recomputation some individuals who make substantial charitable contributions in years in which they receive "bunched income" are unable to take full advantage of the deduction for such contributions. This occurs because, although the bunched income in effect may be spread over the years to which it is attributable, contributions may be deducted only in the year in which they are made. Thus, while the charitable contribution may have been fully deductible if the individual's adjusted gross income for the year were determined before the spreading, once the spreading provisions are applied adjusted gross income for the year in which the contribution is made must be reduced, thereby limiting the amount of the charitable contribution which may be deducted.

To prevent this wastage of charitable contribution deductions your committee has added to the House bill a provision which permits the individual an election to apply the charitable contribution limitations to the adjusted gross income before the bunched income in effect is spread over the years to which it is attributable.

B. Comparison of committee amendments with House provision

There is no comparable provision in the House bill.

C. General explanation of provision

This provision adds to the statute a special rule for determining the amount of charitable contributions deductible by an individual when his "bunched income" is to be spread under the special "averaging" provisions of the tax law. Under this rule the limitation on charitable contributions (20 or 30 percent of adjusted gross income) made in the year in which the bunched income is received may be applied before the income is spread over the years to which it is attributable. Only the net amount of bunched income remaining after the charitable contribution has been deducted will in effect be spread back over the years to which attributable. If the individual elects to deduct charitable contributions in this manner, he cannot include again any portion of the bunched income in determining the limitation on charitable contributions for the year in which the bunched income is received after the income is spread over the years to which it is attributable.

This provision is to apply with respect to taxable years beginning after December 31, 1962.

XXIII. EFFECTIVE DATE OF SECTION 1371(c) OF THE INTERNAL REVENUE CODE OF 1954

(Sec. 23 of bill and sec. 1371(c) of code)

A. Reasons for provision

Under existing law certain small business corporations may elect to have income taxed directly to their shareholders, thereby eliminating tax at the corporate level. For such an election to be valid, however, the corporation must have no more than 10 shareholders and each shareholder must give his consent to the election.

Previously a problem existed as to the proper method of determining the number of shareholders of a corporation in community property States or where the stock of a corporation was held jointly by husband and wife. In 1959 Congress removed this problem by specifically providing how the number of shareholders was to be determined where husband and wife resided in community property States or where they held stock jointly. Congress provided in such cases that the spouses would be treated as one shareholder (Public Law 86–376, approved September 23, 1959). This provision was made effective with respect to taxable years of small business corporations beginning after December 31, 1959. However, cases have come to the attention of your committee in which small business corporations were prevented from making (or continuing) an election to have their income of 1958 and 1959 taxed to their shareholders because husbands and wives in community property States or who held stock jointly have each been counted as a separate shareholder for those

years. The first year with respect to which such an election could be made was 1958.

Your committee does not believe that the rule enacted by Public Law 86–376 for determining the number of shareholders of a small business corporation should be limited to years after 1959, but should apply to all years for which such an election may be made. This will insure the application of the same rules in applying the 10-shareholder limitation for all years in qualifying a small business corporation for such an election. Accordingly, this provision of the bill makes that rule of Public Law 86–376 apply also to years 1958 and 1959.

B. Comparison of committee amendments with House provision

There is no comparable provision in the House bill.

C. General explanation of provision

This bill provides that with respect to the years 1958 and 1959, in determining the number of shareholders of a small business corporation for purposes of the election provided by subchapter S of the Internal Revenue Code (under which shareholders are taxed directly on the corporate earnings), spouses who hold stock of such a corporation jointly or under the community property laws of a State are to be treated as one shareholder; that is, section 1371(c) of the code will now be applicable to such years.

In order to insure that a small business corporation whose status may be affected by this provision will have an opportunity to qualify for treatment under subchapter S, the bill provides a special 1-year period within which a special election may be made to have the earlier effective date of section 1371(c) apply. For the special election to be valid, however, a corporation must have met the statutory requirements of subchapter S in 1958 and 1959, and must have filed a timely election to be subject to subchapter S for those years. Furthermore, each person who is a shareholder at the time of the special election must give his consent and each person who was a shareholder for any taxable year ending before the year in which the special election is made also must give his consent. Finally, where an election (and the requisite consents) has been made, the statute of limitations for assessing additional tax against the corporation or its shareholders is to remain open, or be opened, for 1 year following the date of the election. Tax assessed or credit or refunds granted within this special period of limitations must relate only to changes resulting directly from the election.

XXIV. CERTAIN LOSSES SUSTAINED IN CONVERTING FROM STREET RAILWAY TO BUS OPERATIONS

(Sec. 24 of the bill)

A. Reasons for provision

Present law provides that business losses incurred in one year can be carried back to the 3 prior years and then, to the extent not absorbed by income in those years, carried forward to the 5 succeeding years after the year in which the losses occurred. For most companies which again earn income such a period is long enough to absorb all of their losses against income.

Rapid transit companies in recent years have had a special problem in connection with the very large losses they have incurred in converting from streetcar to bus operations. Because of the size of these losses, most transit companies have spread their conversion to buses over many years—some over as many as 15 years—so that a sufficient period will be available to absorb the losses against income. However, a situation has come to the attention of your committee in which the conversion from streetcars to buses was completed in an 18-month period. It appears that the conversion was made in such a short period because of fraud on the part of the then existing management. Moreover, evidence is available that the then existing management made this conversion in the 18-month period despite the fact that it was pointed out to them by their financial experts that such losses could not be absorbed within the period of the 5-year carryforward.

After the mismanagement was discovered, the company was reorganized and new officers and a new board of directors elected. However, the conversion from streetcars to buses in the 18-month period could not be undone. As a result of this conversion the company sustained a loss of approximately $10,200,000. At the end of the 5-year carryforward period about $5,200,000 of this loss remained unused. While the company has recently been making a small profit, it appears that rate increases may have to be requested if this remaining loss cannot be offset against the income of future years.

Your committee believes that since ordinary prudent, honest management would have spread the conversion over a number of years, a longer carryforward of the unused loss should be permitted. This is a particularly serious problem because of the present inadequacy of our mass transportation system and the fact that a rapid transit system is involved here. Moreover, in this case it is likely that in the long run it will be the users of the transportation who will suffer if the company is not permitted to utilize the benefit of this loss.

B. Comparison of committee amendments with House provision.

There was no comparable provision in the House bill.

C. General explanation of provision

The bill provides that in the case of net operating losses incurred in the calendar years 1953 and 1954, principally as a result of the conversion from streetcar to bus operations, an additional 5 years is to be allowed to offset such losses against income. The bill achieves this result by providing that such losses are to be known as "unused conversion losses" to the extent they still remain unused after the end of the normal 5-year carryforward period. The bill provides that such an unused conversion loss from these 2 years is to be considered a net operating loss sustained in 1959 and therefore available as a net operating loss carryforward to the calendar year 1960 and four subsequent taxable years.

The treatment described above is to apply only for years in which the taxpayer is engaged in the furnishing or sale of transportation on a local electric railroad, trackless trolley system, or bus system. The rates for the transportation in such cases must have been established or approved by a governmental unit, by a public service or public utility commission or similar body.

In the case brought to your committee's attention there is an unused loss of approximately $5,200,000 from the years 1953 and 1954, and it is estimated, based upon anticipated revenues, that from $2 to $3 million of this loss can be offset against income in the additional 5-year period allowed by this bill.

XXV. PENSION PLAN OF LOCAL UNION NO. 435, INTERNATIONAL HOD CARRIERS' BUILDING AND COMMON LABORERS' UNION OF AMERICA

(Sec. 25 of the bill)

A. Reasons for the provision

Under present law, a pension trust is qualified for income tax exemption only if it meets certain requirements relating to coverage of employees and nondiscrimination of contributions or benefits. Where the pension trust is properly qualified, not only is it exempt from Federal taxation with respect to its income, but contributions paid to it by an employer on behalf of his employees are deductible for Federal income tax purposes. Thus, there is considerable incentive for a pension trust to meet the requirements of the Internal Revenue Code and thereby become a qualified trust.

Occasionally, however, it is difficult for a pension trust to achieve qualified status before employer contributions are received by it. This is particularly true in the case of pension plans negotiated under collective-bargaining agreements with many employers, both large and small. Often, considerable time is required to obtain sufficient factual data upon which to insure the actuarial soundness of the plan. Sometimes a formality is not properly performed.

In such cases, where the pension plan operates for some period as a nonqualified plan prior to securing qualification under the Internal Revenue Code, any income it may earn during such period is subject to income tax, thereby reducing amounts which would otherwise serve to provide employee benefits under the plan. In addition, employer contributions are not allowed as deductions unless the employee is given immediate vested rights to the contribution.

Your committee believes these are rather severe consequences, particularly where failure to meet the conditions of the statute for qualification is due to the fact that, because the plan involved many employers, the arrangements could not be worked quickly although it was the initial intention of both the employers and the unions to meet those conditions. If the pension trust has never been operated in a manner which would jeopardize the interest of its beneficiaries, and if, when completed, the pension plan of which the trust is a part conforms with the Internal Revenue Code and has received the approval of the Internal Revenue Service, your committee believes it is just, under such circumstances, to provide that the pension plan be treated as a qualified trust during the intervening period between its inception and the time it actually qualified for tax exemption.

B. Comparison of committee amendments with House provision

There is no comparable provision in the House bill.

C. General explanation of provision

This section of the bill provides that the pension plan of Local Union No. 435, International Hod Carriers' Building and Common Laborers' Union of America, established pursuant to negotiations between the union and the Building Trades Employers' Association of Rochester, which is a qualified trust under section 401(a) of the Internal Revenue Code, is to be treated as having been a qualified trust and to have been exempt from taxation for the period beginning May 1, 1960, and ending April 20, 1961. For this provision to apply however, it must be shown to the satisfaction of the Secretary of the Treasury or his delegate that the trust has not in the period designated been operated in a manner which would jeopardize the interests of its beneficiaries.

Under the bill not only will the income of the pension plan during the specified period be exempt from tax but also contributions made under the plan within such period by employers generally will be deductible by them in determining their Federal income tax liability.

XXVI. CONTINUATION OF PARTNERSHIP YEAR FOR SURVIVING PARTNER IN A TWO-MAN PARTNERSHIP WHERE ONE DIES

(Sec. 26 of bill and sec. 188 of 1939 code)

A. Reasons for provision

The attention of your committee has been called to a case where the partnership provisions of the 1939 Code worked a substantial hardship. The case brought to your committee's attention involves a two-man partnership with a partnership year ending on January 31. The 1939 Code provides that income of partnerships is to be reported by the partners for tax purposes in their year in which, or with which, the partnership year ends. Thus, income from the partnership year ending on January 31, 1946, for example, would be reported by partners on a calendar year basis in their calendar year 1946. However, where one of the partners dies, for example, before the end of December, 1946, the partnership income in that year, which ordinarily would be reported for tax purposes by the partners in 1947, must then be reported by the partners, or their estate, in the calendar year 1946. This can result in a bunching of income, and therefore application of the higher surtax rates, since income of a partner for as long as 23 months may, in this manner, have to be reported in a single year.

At the time of the passage of the 1954 Code, the law was changed to provide that the partnership year was not to close upon the death of a partner but instead was to run to its normal conclusion. In this regard the report of your committee on the 1954 Code stated as follows:

> Under present law there has been the contention that the death of a partner closes the partnership year and [in] the bunching of more than a year's income in the decedent's last year. Where the partnership and the partners are on different taxable years, this would have the effect of concentrating as much as 23 months' income in the final return of the deceased partner, that is, the income for the partner-

ship year ending within his taxable year and the income for the taxable year closed by the partner's death.

The problem presented in the case called to your committee's attention occurred before the 1954 Code provision became applicable. Moreover, here the bunching occurs not only with respect to the deceased partner, but with respect to the surviving partner as well, since a partnership was held to no longer exist upon the death of one of two partners.

B. Comparison of committee amendments with House provision

There is no comparable provision in the House bill.

C. General explanation of provision

The bill adds a provision to the 1939 Internal Revenue Code to provide that the death of a partner in a two-man partnership is not to result in the termination of the partnership, or the closing of the taxable year of the partnership with respect to the surviving partner, prior to the time the partnership year would have closed if neither partner had died nor disposed of his interest. Thus, in the case of a partner dying in 1946 where the partnership year does not end until January 31, 1947, the partnership year would continue to that date and the income for such year would be reported by the surviving partner on his tax return for 1947. This provision is to apply only if the surviving partner so elects within 1 year after the date of enactment of this provision.

This amendment applies to taxable years of a partnership beginning after December 31, 1946, to which the Internal Revenue Code of 1939 applies. Generally the 1939 Code applied to partnership taxable year beginning before January 1, 1955. The bill also provides that if refund or credit for an overpayment resulting from the application of this provision is prevented by the operation of any law or rule of law (other than those relating to closing agreements or compromises) the refund or credit of the overpayment may nevertheless be made if the claim is filed within 1 year after the date of enactment of this bill.

XXVII. TREATIES

(Sec. 27 of bill)

Section 7852(d) of the code provides that no provision of the internal revenue title is to apply where its application would be contrary to any treaty obligation of the United States in effect on the date of the enactment of the Internal Revenue Code.

The House bill provided that section 7852(d) of the code was not to apply to any provision contained in this bill and that if any provision in this bill would contravene any existing tax treaty, then the new statutory law was to have precedence over the prior treaty obligation.

Numerous witnesses before your committee have expressed the view that provisions in the bill would be contrary to tax treaty obligations of the United States. Your committee has no desire to abrogate any provision in any treaty. For that reason, it has substituted for the provision in the House bill, language which provides that no provision of this bill is to apply in any case where its appli-

cation would be contrary to any treaty obligation of the United States. The Secretary of the Treasury in his appearance before your committee has indicated that he is in agreement with the adding of this provision.

XXVIII. NEW ELECTION TO FILE SEPARATE RETURNS WHERE CONSOLIDATED RETURN HAD BEEN FILED

The Internal Revenue Code leaves to regulations issued by the Treasury Department requirements as to the filing of consolidated returns by an affiliated group and the requirements for changing from a consolidated return to separate returns. Generally it has been held that a consolidated return once filed must be continued in subsequent years unless there is a significant change in the tax laws. Your committee agrees with the House that enactment of this bill constitutes a significant change in the tax laws and that a new election to file separate returns where a consolidated return has previously been filed should be available for the first taxable year ending after the date of enactment of this bill.

TECHNICAL EXPLANATION OF THE BILL

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TECHNICAL EXPLANATION OF THE BILL

SECTION 1. SHORT TITLE, ETC.

(a) *Short title.*—Section 1(a) of the bill provides that the bill may be cited as the "Revenue Act of 1962."

(b) *Table of contents.*—Section 1(b) of the bill consists of a table of contents for the bill.

(c) *Amendment of 1954 Code.*—Section 1(c) of the bill provides that, except as otherwise expressly provided, whenever in the bill an amendment or repeal is expressed in terms of an amendment to (or repeal of) a section or other provision, the reference is to be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

SECTION 2. CREDIT FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY

(a) *Allowance of credit.*—Section 2(a) of the bill redesignates section 38 of the code as section 39 and inserts a new section 38 in part IV of subchapter A of chapter 1 (relating to credits against tax).

Subsection (a) of the new section 38 provides that there is to be allowed, as a credit against the tax imposed by chapter 1 of the code, the amount determined under the new subpart B, added by section 2(b) of the bill. Subsection (b) of the new section 38 requires the Secretary of the Treasury or his delegate to prescribe such regulations as may be necessary to carry out the purposes of the new section 38 and the new subpart B.

(b) *Rules for computing credit.*—Section 2(b) of the bill adds a new subpart B to part IV of subchapter A of chapter 1 of the code. The new subpart consists of three sections (secs. 46–48) which are explained below.

SECTION 46. AMOUNT OF CREDIT

(a) *Determination of amount.*—Paragraph (1) of section 46(a) provides in general that the credit allowed for the taxable year is to be an amount equal to 7 percent of the qualified investment as defined in subsection (c) of section 46. Under paragraph (2) of section 46(a) the amount of the credit may not exceed so much of the liability for tax for the taxable year as does not exceed $25,000 plus 25 percent of so much of such liability as exceeds $25,000. However, the $25,000 amount provided by section 46(a)(2) is reduced in the case of certain married individuals filing separate returns (see sec. 46(a)(4)), corporations which are members of affiliated groups (see sec. 46(a)(5)), trusts and estates (see sec. 48(f)(3)), and certain other special types of taxpayers referred to in section 46(d).

Under paragraph (3) of section 46(a), the liability for tax for the taxable year is defined as the tax imposed by chapter 1 (including the 2-percent tax on consolidated taxable income) reduced by the sum

of the credits against the income tax allowed by sections 33, 34, 35, and 37. For purposes of determining the liability for tax, the taxes imposed by sections 531 and 541 (relating, respectively, to the accumulated earnings tax and the personal holding company tax) are not considered taxes imposed by chapter 1. Thus, the liability for tax as defined in section 46(a)(3) and the credit allowable for the taxable year under section 38 are determined before computing any tax imposed by section 531 or 541.

Paragraph (4) of section 46(a) provides generally that, in the case of separate returns filed by a husband and wife, the credit allowed to each may not exceed so much of the liability for tax for the taxable year as does not exceed $12,500 plus 25 percent of so much of such liability as exceeds $12,500. However, this reduction in the limitation applies only if the taxpayer's spouse is entitled to an investment credit for the taxable year of such spouse which ends with, or within, the taxpayer's taxable year. Such spouse may be entitled to an investment credit either because of qualified investment made in such taxable year for (whether directly made or whether allocated to such spouse by, for example, a subch. S corporation or a partnership), or because of an unused credit carryback or carryover to, such taxable year.

Paragraph (5) of section 46(a) provides generally that the $25,000 amount specified in subparagraphs (A) and (B) of section 46(a)(2) is to be reduced for each corporation which is a member of an affiliated group by apportioning $25,000 among the members of such group in the manner prescribed by regulations of the Secretary of the Treasury or his delegate. An affiliated group within the meaning of section 46(a)(5) is one described in section 1504(a), except that any corporation may be treated as a member of an affiliated group. Thus, an affiliated group for purposes of section 46(a)(5) may include any of the corporations excluded by section 1504(b) from being a member of an affiliated group for purposes of filing a consolidated return. For example, an affiliated group within the meaning of section 46(a)(5) could include a corporation exempt from taxation under section 501 or a foreign corporation.

The application of the limitation provisions of section 46(a) may be illustrated by the following example:

The qualified investment of an unmarried taxpayer is $2,050,000. His liability for tax for the taxable year is $185,000. The credit computed without regard to the limitation in section 46(a)(2) is $143,500 (7 percent of $2,050,000). The allowable credit for the taxable year is $65,000 ($25,000 plus 25 percent of $160,000).

(b) *Carryback and carryover of unused credits.*—Section 46(b) as passed by the House provided a 5-year carryover for unused credits. Your committee has added a 3-year carryback for unused credits.

Paragraph (1) of section 46(b) provides for a 3-year carryback and a 5-year carryover of any unused credit. Under this provision, if the credit earned during the taxable year exceeds the limitation under section 46(a)(2) for that year (hereinafter referred to as "unused credit year"), the excess (the credit earned but not used to reduce tax for that year) is a carryback to each of the 3 preceding taxable years, and a carryover to each of the 5 succeeding taxable years and, subject to the limitation of paragraph (2) of section 46(b), is to be added to the amount allowable as an investment credit for those

years. Such excess, however, may be a carryback only to taxable years ending after June 30, 1962. The entire amount of the excess (the unused credit for any unused credit year) must be carried first to the earliest of the 8 taxable years to which section 46(b) permits it to be carried. It may then be carried to each of the other 7 taxable years (in order of time) to the extent that, because of the limitation provided in paragraph (2) of section 46(b), it could not be added for a prior taxable year.

Paragraph (2) of section 46(b) provides that the amount of the unused credit from an unused credit year that may be added to the amount allowable as an investment credit for any of the 3 preceding or 5 succeeding taxable years is not to exceed the amount by which the limitation (determined under sec. 46(a)(2)) for such preceding or succeeding taxable year exceeds the sum of (1) the investment credit allowable for such year by reason of investment made in such year, and (2) other allowable unused credits which are attributable to years prior to the taxable year in which the unused credit originated. Thus, before an investment credit carryback or carryover from an unused credit year may be taken into account in any preceding or succeeding taxable year, the credit allowable for such preceding or succeeding taxable year (determined without regard to carrybacks or carryovers of unused credits to that year) will first be applied. Unused credits originating from taxable years prior to the unused credit year will be applied next. To the extent that the investment credit carryback or carryover from an unused credit year cannot be used in a particular preceding or succeeding taxable year because the sum of the credit earned and allowable in that year and the carrybacks and carryovers to that year from taxable years preceding the unused credit year exceed the limitation on allowable credit for such year, the carryback or carryover will be carried forward to the next succeeding taxable year.

Effect of net operating loss carryback

Paragraph (3) of section 46(b) provides that to the extent that an unused credit arises by reason of a net operating loss carryback, subparagraph (A) of section 46(b)(1) will not apply. Although no investment credit carryback of an unused credit will be allowed to the extent that the unused credit arises from the application of a net operating loss carryback, the full amount of the unused credit so arising will be available for use as an investment credit carryover. Thus, assume a taxpayer's credit based on investments in 1965 is $25,000, and such credit is allowable in full for that year. Subsequently, such taxpayer has a net operating loss that he carries back to 1965 which eliminates the taxpayer's liability for tax for that year. The $25,000 credit (no longer allowable for the year 1965) is an investment credit carryover that may be carried forward to the 5 succeeding taxable years but is not to be treated as an investment credit carryback.

Taxable years beginning before July 1, 1962

Paragraph (4) of section 46(b) provides a transition rule relating to the amount of an investment credit carryback that may be added under section 46(b)(1) for a taxable year beginning before July 1, 1962, and ending after June 30, 1962. For purposes of determining the amount that may be carried back to such a taxable year, the

amount of the limitation provided by section 46(a)(2) will be considered to be an amount which bears the same ratio to such limitation as the number of days in such year after June 30, 1962, bears to the total number of days in such year.

The application of the carryback and carryover of the unused credit provided for in subsection (b) of section 46 may be illustrated by the following examples:

Example 1.—A new taxpayer's credit based on his investment for the taxable year 1963 amounts to $120,000, and the limitation under section 46(a)(2) is $110,000. The taxpayer's unused credit for 1963 amounts to $10,000 ($120,000 minus $110,000), which he may carry forward to 1964 and the 4 succeeding taxable years (there is no carryback because 1963 is the taxpayer's first taxable year). The credit based on his investment for 1964 is $135,000, and the limitation under section 46(a)(2) is $120,000. Since the taxpayer is limited to a credit of $120,000 for 1964, his total unused credits to be carried forward to 1965 amount to $25,000, $10,000 from 1963 and $15,000 from 1964. There is no carryback to 1963 of the $15,000 unused credit from 1964 because the credit based on investment for 1963 already exceeds the limitation. The credit based on the taxpayer's investment for 1965 is $135,000, and the limitation under section 46(a)(2) is $140,000. The taxpayer first applies the $135,000 for 1965 against the $140,000 limitation. He next applies any unused credit carried forward from 1963 against the remaining $5,000 allowable. Since the $10,000 credit carried forward from 1963 is in excess of the $5,000 remaining amount allowable for 1965, he has unused credits to carry over to 1966 of $20,000, $5,000 from 1963 and $15,000 from 1964.

Example 2.—X files his tax return on the basis of a calendar year. X's credit based on his investment, and the limitation under section 46(a)(2) for each of the taxable years 1962 through 1968 is as follows:

	Credit	Limitation
1962	$75,000	$200,000
1963	250,000	160,000
1964	200,000	210,000
1965	210,000	230,000
1966	220,000	260,000
1967	260,000	220,000
1968	270,000	280,000

X's credit for 1962 (for investment in property acquired after June 30, 1962) is allowable in full since it is less than the limitation for that year. His credit for 1963 of $250,000 is limited by section 46(a)(2) to $160,000. The unused credit for that year of $90,000 is an investment credit carryback to 1962, and an investment credit carryover to 1964 through 1968. The amount of the 1963 unused credit that may be added for 1962 is limited to $25,822 ($200,000×184/365, less $75,000) by reason of the application of section 46(b)(4). The balance of the 1963 unused credit, $64,178 ($90,000 less $25,822) is carried forward to 1964; $10,000 of the 1963 unused credit may be added to the amount of the credit allowable in 1964 since the limitation on the credit for 1964 exceeds the credit earned for that year by $10,000 ($210,000 less $200,000). The $54,178 balance of the 1963 unused credit ($64,178 less $10,000) is then carried forward to 1965;

$20,000 of the 1963 unused credit may be added to 1965 since the limitation on the credit for 1965 exceeds the credit earned for that year by $20,000 ($230,000 less $210,000). The remaining balance of the 1963 unused credit, $34,178, is carried to 1966 and may be added in full to the amount of the credit allowable in 1966 since the limitation for that year exceeds the credit earned for that year by more than the amount of the carryover. The unused credit from 1967 of $40,000 ($260,000 credit earned less $220,000 limitation on credit) is an investment credit carryback to 1964, 1965, and 1966, and a carryover to 1968 and the 4 succeeding taxable years. None of the 1967 unused credit may be added for 1964 or 1965 because for each of those years the sum of the credit earned and allowable and the additions on account of unused credits from prior unused credit years exceeds the limitation for such years; $5,822 of the 1967 unused credit may be added for 1966 since the limitation for that year ($260,000) exceeds by $5,822 the sum of the credit earned and allowable for that year ($220,000) and the additions on account of the 1963 unused credit ($34,178); $10,000 of the 1967 unused credit may be added for 1968, and the balance ($24,178) may be carried forward to the 4 succeeding years.

(c) *Qualified investment.*—Paragraph (1) of section 46(c) defines "qualified investment" to mean, with respect to any taxable year, the aggregate of the applicable percentage of the basis of each new section 38 property placed in service by the taxpayer during such taxable year, plus the aggregate of the applicable percentage of the cost of each used section 38 property placed in service by the taxpayer during such taxable year. Under paragraph (2) of section 46(c), the applicable percentage to be applied to the basis (or cost) is (1) 33⅓ percent if the estimated useful life is 4 years or more but less than 6 years, (2) 66⅔ percent if the estimated useful life is 6 years or more but less than 8 years, and (3) 100 percent if the estimated useful life is 8 years or more.

The basis of "new section 38 property" is to be determined under the general rules for determining the basis of property. Thus, the basis of property purchased or constructed would generally be its cost. If property is acquired in a nontaxable exchange to which section 1031 applies by trading in old property and paying a cash difference, the basis of the newly acquired property would be equal to the adjusted basis of the old property, plus the cash paid. However, the basis adjustment required by section 48(g) is to be disregarded for purposes of computing the credit.

The cost of each "used section 38 property" is to be determined in accordance with section 48(c)(3)(B) and with regard to section 48(g). However, the aggregate cost of used section 38 property which may be taken into account in any taxable year in computing qualified investment cannot exceed $50,000. (See sec. 48(c)(2).)

The credit will apply to new and used property only for the first taxable year such property is placed in service by the taxpayer. The date on which property is placed in service is the first date depreciation would be allowable to the taxpayer if he computed his depreciation deduction on a daily basis. Thus, in determining the date an asset is placed in service, the fact that the taxpayer, in computing his depreciation allowance, uses an assumed timing of additions under one of

the "averaging conventions" is to be disregarded, but only for the purposes of the investment credit.

The estimated useful life of any property is to be determined as of the time such property is placed in service by the taxpayer, and with reference to the useful life in the hands of the taxpayer. Thus, if a taxpayer acquires used section 38 property with a remaining useful life of 3 years in his hands, such property will not qualify regardless of the original estimated useful life to the previous owner. See section 48(d) for the useful life to be used by certain lessees. The estimate of the useful life is to be based on the facts and circumstances known on the date the asset is placed in service.

An estimated useful life must be assigned to each separate property. Thus, if a taxpayer is using a multiple-asset account, he must assign a useful life to each asset in such account for the purpose of computing his qualified investment. If a taxpayer is using a method of depreciation, such as the units of production method, which does not measure useful life in terms of years, he must estimate useful life in years in order to compute his qualified investment.

The provisions of paragraphs (1) and (2) of section 46(c) may be illustrated by the following examples:

Example 1.—Corporation Y acquires and places in service during 1963 the following new and used section 38 assets:

Property	Estimated useful life (years)	Basis or cost
A (new)	5	$60,000
B (new)	10	90,000
C (new)	6	150,000
D (used)	4	30,000

Corporation Y's qualified investment for 1963 is $220,000 determined in the following manner:

Property	Basis or cost times applicable percentage	Qualified investment
A	$60,000×33⅓ percent	$20,000
B	$90,000×100 percent	90,000
C	$150,000×66⅔ percent	100,000
D	$30,000×33⅓ percent	10,000
Total		220,000

Example 2.—Mr. X, unmarried, owns and operates a business as a sole proprietorship and reports income on a calendar-year basis. He is also a member of the XYZ partnership, which is also on a calendar-year basis. During 1963 Mr. X acquires and places in service in his sole proprietorship a new section 38 property having an estimated useful life of 9 years and a basis of $25,000. Also during 1963 the XYZ partnership acquires and places in service a new section 38 property having an estimated useful life of 4 years to the partnership and a basis of $18,000.

X's share of the basis of the new section 38 property acquired by partnership XYZ is $6,000. X's qualified investment for 1963 is $27,000, composed of $25,000 from his sole proprietorship (basis of

$25,000 times applicable percentage, 100 percent), and $2,000 attributable to the property of the XYZ partnership (basis of $6,000 times applicable percentage, 33⅓ percent).

Public utility property

Paragraph (3)(A) of section 46(c) provides that in the case of section 38 property which is public utility property, the amount of the qualified investment is to be three-sevenths of the amount ascertained under section 46(c)(1) with respect to such property.

Paragraph (3)(B) of section 46(c) defines "public utility property" as property used predominantly in the trade or business of the furnishing or sale of (i) electrical energy, water, or sewage disposal services, (ii) gas through a local distribution system, (iii) telephone service, or (iv) telegraph service by means of domestic telegraph operations (as defined in sec. 222(a)(5) of the Communications Act of 1934, as amended; 47 U.S.C., sec. 222(a)(5)), if the rates for such furnishing or sale have been established or approved by a State (as defined in sec. 7701(a)(10) of the code) or political subdivision thereof, by an agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof. The term "established or approved" by a State, etc., includes the filing of a schedule of rates with any of the named bodies having the power to approve such rates, even though such body has taken no action on the filed schedule.

If a taxpayer is engaged in one or more regulated activities enumerated in section 46(c)(3)(B) (hereinafter referred to as a utility activity) and is also engaged in a separate trade or business that is not considered a utility activity, property used in the latter trade or business is not subject to the reduction contained in paragraph (3)(A) of section 46(c). If property is used by a taxpayer both in a utility activity and a nonutility activity, the characterization of such property is to be based on the predominant use of such property during the taxable year the property is placed in service. Once property is characterized as public utility property, the fact that in any subsequent year such property is used predominantly in the nonutility business is to be disregarded.

"Public utility property" includes property leased to a taxpayer which uses such property predominantly in a utility activity. Thus, property leased to a taxpayer which uses the property predominantly in a utility activity during a taxable year is to be treated as public utility property for purposes of computing the lessor's credit. "Public utility property" also includes property which is leased to others by a taxpayer where the leasing of such property is part of its utility activity.

Section 38 property which is not public utility property is not subject to the three-sevenths reduction contained in section 46(c)(3)(A). Thus, for example, in the case of property which is used predominantly in international telegraph operations, which is not used predominantly outside the United States, and which otherwise qualifies as section 38 property, the qualified investment is to be determined without reduction by reason of section 46(c)(3)(A).

The provisions of section 46(c)(3) may be illustrated by the following example:

Corporation X is engaged in a trade or business of furnishing telephone services, the rates of which have been established by a public

utility commission. Corporation X is also engaged in a separate nonutility trade or business. During 1963 corporation X acquires and places in service two new section 38 properties, each with a basis of $30,000 and an estimated useful life of 7 years. One of these properties is used exclusively in the utility activity. The other property is also used at times in the utility activity, but is used in the separate nonutility trade or business more than 50 percent of the time during the taxable year 1963. Corporation X's qualified investment is $28,571 which includes $20,000 attributable to nonutility property ($30,000 basis times applicable percentage, 66⅔ percent) plus $8,571 attributable to public utility property (three-sevenths times ($30,000 basis times applicable percentage, 66⅔ percent)).

Certain replacement property

Paragraph (4) of section 46(c) is a new provision added by your committee. This new paragraph provides that, for purposes of section 46(c), if section 38 property is placed in service by the taxpayer to replace property which was destroyed or damaged by fire, storm, shipwreck, or other casualty, or was stolen, the basis (or cost in the case of used property) of such section 38 property which (but for this paragraph) would be taken into account under section 46(c)(1) as qualified investment, shall be reduced by an amount equal to the amount received by the taxpayer as compensation, or otherwise, for such property so destroyed, etc., or by an amount equal to the adjusted basis of such property so destroyed, etc., whichever is the lesser. However, the above rule shall not apply in any case in which the reduction in qualified investment attributable to the substitution required by section 47(a)(1) with respect to the property so destroyed, damaged, or stolen (determined without regard to section 47(a)(4)), is greater than the reduction in basis (or cost) described in the preceding sentence. In order to constitute replacement property, the newly acquired section 38 property need not be placed in service within the same taxable year of the destruction, etc., of the replaced property.

The provisions of paragraph (4) of section 46(c) may be illustrated by the following examples:

Example 1.—On January 1, 1964, corporation X acquires and places in service a new section 38 asset with a basis of $30,000 and a useful life of 6 years. The qualified investment with respect to such asset is $20,000 ($30,000 basis × 66⅔ percent, applicable percentage). On January 1, 1965, such asset is destroyed by fire. X receives $23,000 in insurance proceeds as compensation for the destroyed property and on December 15, 1965, purchases for $35,000 an asset to replace the asset that was destroyed. The adjusted basis of the destroyed asset on January 1, 1965 is $24,500. The basis of the replacement asset must be reduced for purposes of the new subpart B by $23,000, since that sum is less than the adjusted basis of the destroyed property on January 1, 1965 ($24,500), and is greater than the reduction in qualified investment ($20,000) which would have been required had section 47(a)(1) been applicable. Since section 46(c)(4) applies, section 47(a)(1) does not apply. (See sec. 47(a)(4).)

Example 2.—Assume the same facts as in example 1, except that the insurance proceeds are $17,000. In such case, no reduction in the basis of the replacement asset is required since the reduction in qualified investment under section 47(a)(1) ($20,000) is greater than the reduction in basis ($17,000) which would have been required under

section 46(c)(4). Since section 46(c)(4) is not applicable, the credit attributable to the asset replaced will be recomputed by applying section 47(a)(1).

(*d*) *Limitations with respect to certain persons.*—Subsection (d) of section 46 limits the applicability of the credit with respect to certain persons. Paragraph (1) of section 46(d) provides that both the qualified investment and the $25,000 amount specified under subparagraphs (A) and (B) of section 46(a)(2) are to be equal to a ratable share of such items in the case of the following organizations:

(1) mutual savings banks, cooperative banks, and domestic building and loan associations, to which section 593 applies;

(2) regulated investment companies and real estate investment trusts subject to tax under subchapter M; and

(3) cooperative organizations described in section 1381(a).

Under paragraph (2)(A) of section 46(d), in the case of a mutual savings bank, etc., its ratable share of the qualified investment and the $25,000 amount specified in subparagraphs (A) and (B) of section 46(a)(2) is equal to 50 percent of such items.

Under paragraph (2)(B) of section 46(d), in the case of a regulated investment company or a real estate investment trust, the qualified investment and the $25,000 amount specified in subparagraphs (A) and (B) of section 46(a)(2) are to be taken into account in the same proportion as its taxable income (as defined in sec. 852(b)(2) or sec. 857(b)(2), respectively) bears to such taxable income computed without regard to the deduction for dividends paid (as defined in sec. 852(b)(2)(D) or 857(b)(2)(C), respectively).

Under paragraph (2)(C) of section 46(d), a cooperative organization described in section 1381(a) is to take into account its qualified investment and the $25,000 amount specified in subparagraphs (A) and (B) of section 46(a)(2) in the same proportion as its taxable income bears to its taxable income increased by amounts to which section 1382 (b) or (c) applies and similar amounts the tax treatment of which is determined without regard to subchapter T (sec. 1381 and following). Thus, in the case of a taxable year of a cooperative organization beginning before January 1, 1963, the denominator of the proportion for such organization is determined by adding to its taxable income any patronage dividends which are excluded or deducted and any nonpatronage distributions which are deducted under section 522(b)(1). In the case of any taxable year of the organization beginning after December 31, 1962, the denominator is determined by adding to taxable income (in addition to amounts to which sec. 1382 (b) or (c) applies) any amounts of the type described in the preceding sentence which are excluded or deducted without regard to section 1382 (b) or (c) because they are attributable to patronage occurring before 1963.

If any of these special taxpayers to which section 46(d) applies are members of an affiliated group as defined in section 46(a)(5), the $25,000 amount specified in subparagraphs (A) and (B) of section 46(a)(2) is to be reduced in accordance with section 46(a)(5) before determining the ratable share of such item under section 46(d).

The provisions of section 46(d) may be illustrated by the following example:

The total qualified investment of a regulated investment company is $150,000, and its investment company taxable income is $50,000

after taking into account the deduction for dividends paid provided by section 852(b)(2)(D), and $1 million without regard to such deduction. Such organization's qualified investment would be $7,500 $\left(\$150{,}000\times\frac{\$50{,}000}{\$1{,}000{,}000}\right)$. Similarly, the $25,000 amount specified in subparagraphs (A) and (B) of section 46(a)(2) would be reduced to $1,250 $\left(\$25{,}000\times\frac{\$50{,}000}{\$1{,}000{,}000}\right)$, and the 25-percent limitation of section 46(a)(2)(B) would apply to the tax liability in excess of $1,250.

SECTION 47. CERTAIN DISPOSITIONS, ETC., OF SECTION 38 PROPERTY

(a) *In general.*—Section 47 provides, in general, for an adjustment of prior credits (including credit carrybacks and carryovers) and an increase in the tax imposed by chapter 1 if property (1) is disposed of or otherwise ceases to be section 38 property with respect to the taxpayer before the close of the useful life which was taken into account with respect to such property in computing the credit, or (2) becomes public utility property. Subsection (a) of section 47 provides that adjustments due to the application of section 47 and increases in tax resulting from such adjustments are to be determined under regulations prescribed by the Secretary of the Treasury or his delegate.

Early disposition, etc.

Under paragraph (1) of section 47(a), the tax for a taxable year in which property is disposed of or otherwise ceases to be section 38 property before the close of the useful life which was taken into account in computing the credit is to be increased by the amount by which the credits allowed under section 38 for all prior taxable years would have been decreased by reason of adjustments of the credits for such taxable years. Such adjustment is to be made by recomputing qualified investment for the year in which the basis (or cost) of the property that ceases to be section 38 property was included in qualified investment and by recomputing the credit (and credit carrybacks and carryovers) accordingly. Qualified investment is to be recomputed by substituting, in lieu of the estimated useful life of the property that was originally taken into account in applying the applicable percentage, the period beginning with the time such property was placed in service by the taxpayer and ending with the time such property ceased to be section 38 property. This period is hereinafter referred to as the actual period of use. In determining the amount of the aggregate decrease in the credits allowed for all prior taxable years, due regard is to be accorded any previous recomputations of qualified investment, credits, and credit carrybacks and carryovers resulting from a prior application of section 47. Of course, if the actual period of use would have no effect on the appropriate applicable percentage to be applied, no adjustment is necessary. Thus, for example, if the estimated useful life is 10 years, and a disposition occurs resulting in an actual period of use of 8 years, no adjustment results, since the applicable percentage remains 100 percent in either case.

Except as provided in section 47(b), whenever section 38 property is disposed of, such property ceases to be section 38 property with respect to the taxpayer. In general, property will be considered dis-

posed of whenever it is sold, exchanged, transferred, distributed, involuntarily converted, or disposed of by gift. Thus, a cessation will occur when property is contributed to a partnership or to a corporation. (However, see sec. 47(b) for an exception where the contribution of property constitutes a mere change in the form of operating the trade or business.) Generally, the lease of property is not considered to be a disposition for purposes of applying section 47. However, if a taxpayer leases out property which he would ordinarily dispose of by sale or exchange and it appears that a purpose of the lease is to avoid the application of section 47, then such lease will be considered a disposition.

Additional examples of property ceasing to be section 38 property include (1) property (or a portion thereof) which is no longer subject to depreciation with respect to the taxpayer because, for example, it is shifted from a business to a personal use, and (2) property which is used in any taxable year predominantly outside the United States, by a governmental unit, etc. Similarly, property of a partnership (or subch. S corporation or estate or trust) ceases to be section 38 property with respect to the taxpayer (partner, shareholder, or beneficiary) when such taxpayer sells his interest in the partnership (or shares of stock or beneficial interest). Furthermore, when section 38 property is leased, and the lessor elects to treat the lessee as the purchaser of the property under section 48(d), a termination of the lease will result in the application of section 47 with respect to the lessee, unless the property does not cease to be section 38 property with respect to the lessee.

The provisions of section 47(a)(1) may be illustrated by the following example:

Corporation X acquires and places in service a new section 38 asset on January 1, 1963. Such asset has a basis of $30,000 (determined without regard to sec. 48(g)) and an estimated useful life of 8 years. Assuming this is the only section 38 asset corporation X places in service during its taxable year ending December 31, 1963, X's qualified investment is $30,000 ($30,000 basis times applicable percentage, 100 percent). Such investment entitles X to a credit of $2,100 (7 percent times $30,000). Corporation X's liability for tax for 1963 is $100,000, and X reduces its tax liability by the full $2,100. On January 1, 1968, corporation X sells such asset. There will be added to the taxes imposed by chapter 1 for X's taxable year ended December 31, 1968, $1,400 which is the aggregate decrease in credits allowed resulting solely from substituting a 5-year life for such asset in computing qualified investment in 1963. The sum of $1,400 is arrived at by first applying an applicable percentage of 33⅓ percent to the basis, resulting in an adjusted qualified investment of $10,000 ($30,000 basis times 33⅓ percent, the applicable percentage based on the actual period of use of 5 years). Since the recomputed qualified investment results in an adjusted credit of $700 (7 percent times $10,000), the aggregate decrease in credits is $1,400 ($2,100 credit allowed minus $700 adjusted credit).

Property becomes public utility property

Section 47(a)(2) provides that the credit is to be adjusted if during any taxable year any property previously taken into account in determining qualified investment as nonutility property becomes

public utility property. Property becomes public utility property if in any 1 taxable year the property is used predominantly in a trade or business described in section 46(c)(3)(B) by the taxpayer or by a person leasing such property from the taxpayer. Once such property becomes public utility property in the hands of the taxpayer, the fact that in any subsequent year such property is used by such taxpayer predominantly in a nonutility activity is to be disregarded. (See sec. 46(c)(3)(B) for the definition of public utility property.)

In such a case, the tax liability for the taxable year in which the property becomes public utility property is to be increased by the amount that the credits allowed under section 38 for all prior taxable years is decreased by the adjustment. The adjustment is to be made by treating the property as public utility property beginning with the year the property was placed in service, but with due regard to the use of the property as nonutility property before such change in use. For purposes of the adjustment, it is assumed that the property will continue to be used as section 38 public utility property for the estimated useful life of the property which was taken into account in computing the credit in the year the property was placed in service.

If property becomes public utility property before the close of the useful life which was taken into account in computing the credit under section 38, the proper applicable percentage to be used in recomputing qualified investment is determined by adding (1) the applicable percentage (either 0, 33⅓, or 66⅔ percent) earned by the property as nonpublic utility property prior to the change in use, and (2) three-sevenths times the difference between the applicable percentage originally taken into account in computing the credit in the year the taxpayer placed the property in service and the applicable percentage determined in (1). Thus, if property with an original estimated useful life of 10 years is used predominantly as public utility property after use as nonutility property for 5 years, the applicable percentage to be used in recomputing qualified investment is 61.9 percent. This percentage is arrived at by adding 33⅓ percent (the applicable percentage earned by the property as nonpublic utility property) plus three-sevenths of 66⅔ percent (100 percent original applicable percentage, less 33⅓ percent, applicable percentage earned as nonutility property).

If property becomes public utility property and section 47(a)(2) applies, and if such property is subsequently disposed of or used in a manner causing section 47(a)(1) to apply, proper adjustment for the fact that section 47(a)(2) has previously applied is to be made in applying section 47(a)(1).

Carrybacks and carryovers adjusted

Section 47(a)(3) provides that carrybacks and carryovers of unused credits under section 46(b) are to be adjusted by reason of a disposition or other cessation described in section 47(a)(1), or by reason of a change in use described in section 47(a)(2). Thus, even if the recomputation of qualified investment required by section 47(a)(1) does not result in a decrease in the credits allowed, credit carrybacks and carryovers are to be adjusted.

The provisions of section 47(a)(3) may be illustrated by the following example:

In 1963, corporation X, a new taxpayer, acquired and placed in service a number of section 38 assets. One of these was asset A which

has a basis of $300,000 and an estimated useful life of 8 years. X's qualified investment and liability for tax for such year were $2,300,000 and $525,000 respectively. In 1963, X's tentative credit was $161,000 (7 percent times $2,300,000), but because of the limitation contained in section 46(a)(2) the credit allowed for such year was $150,000 ($25,000 plus 25 percent of $500,000). Therefore, an $11,000 credit carryover was available for 1964 and succeeding years. On January 1, 1970, X trades in asset A in exchange for a new asset. Under these facts, corporation X must adjust its credit for 1963 by recomputing the qualified investment attributable to asset A. The original qualified investment with respect to asset A was $300,000 ($300,000 basis times applicable percentage, 100 percent); the recomputed qualified investment is $200,000 ($300,000 basis times applicable percentage, 66⅔ percent based on the actual period of use of asset A). Therefore, the total recomputed qualified investment is $2,200,000 ($2,300,000 minus $100,000). In this case, the adjustment of the credit for 1963 will not affect the credit allowed in 1963 but will reduce the credit allowable as a carryover to 1964 and succeeding years. This is because in recomputing the credit, X's credit is reduced to $154,000 (7 percent times $2,200,000). Since X's adjusted credit is still in excess of the limitation of $150,000 for 1963, there is no decrease in credits allowed in 1963, and hence no increase in X's liability for tax for 1970 attributable to credits allowed in 1963. Thus, only the $11,000 unused credit carryover from 1963 is affected by the recomputation. Such carryover as adjusted is $4,000 ($154,000 adjusted credit for 1963 minus $150,000 credit used in 1963). To the extent more than $4,000 of the original carryover from 1963 has been used by the taxpayer as a credit against tax for 1964 or any succeeding year, such credits shall be adjusted and the decrease attributable thereto will be added to X's 1970 tax.

Property destroyed by casualty, etc.

Paragraph (4) of section 47(a) was added to the bill by your committee. Paragraph (4) provides an exception to section 47(a)(1). If (1) any property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, on account of its destruction or damage by fire, storm, shipwreck, or other casualty, or by reason of its theft, and (2) section 38 property is placed in service by the taxpayer to replace the property described in (1), and (3) the reduction in basis (or cost) of the replacement property resulting from the application of the first sentence of section 46(c)(4) is greater than the reduction in qualified investment which (but for this paragraph) would be made by reason of the substitution required by section 47(a)(1) with respect to the destroyed, etc., property, then, no increase in tax shall be made under section 47(a)(1) and no adjustment in unused credit carryovers will be made under section 47(a)(3). (See the discussion of sec. 46(c)(4) in this report for examples which illustrate the application of this provision.)

(b) *Section not to apply in certain cases.*—Subsection (b) of section 47 provides additional exceptions to the adjustments required by section 47(a).

The first exception provides that section 47(a) will have no application to the transfer of property which arises by reason of an individual taxpayer's death. Thus, on the death of an individual tax-

payer, the transfer of the decedent's property interests to his personal representative or heirs will be disregarded. Nor will section 47(a) apply to the transfer of a deceased taxpayer's interest held in joint tenancy (either as a joint tenant, or a tenant by the entirety) to the surviving owners of the property. The effect of this provision is that all properties held by a decedent at the time of his death for which the credit has been granted will be deemed held by the decedent for the useful life estimated by the decedent in computing his credits.

Another exception provided by subsection (b) of section 47 is that section 47(a) will not apply to the transfer of property to the acquiring corporation in a transaction to which section 381(a) applies. (See sec. 381(c)(23) for the treatment to be accorded the acquiring corporation with respect to the credits of the acquired corporation, including the sec. 47 adjustments with respect to dispositions by the acquiring corporation of property transferred by the acquired corporation.)

In addition, subsection (b) of section 47 provides, in effect, a suspension of the application of section 47(a) where there has been a mere change in the form of conducting a trade or business so long as (1) the property is retained in such trade or business as section 38 property, and (2) the taxpayer retains a substantial interest in such trade or business. On the occurrence of any event which results in a failure to meet either of the conditions described above, the property will be deemed to cease to be section 38 property when such event occurs. Thus, in determining whether the property ceases to be section 38 property before the close of its estimated useful life, the period the property was held as section 38 property before the mere change in form of conducting the trade or business will be tacked on to the period beginning with the change in form and ending with the occurrence of the event which results in a failure to meet either of the conditions specified in the first sentence of this paragraph.

The phrase "a mere change in the form of conducting the trade or business" (whether through incorporation, the formation of a partnership, or otherwise) applies only to cases where the properties of a trade or business are transferred. Thus, the transfer of section 38 assets to a newly formed corporation in a transaction to which section 351 applies will not fall within the scope of the exception unless the transaction involves the transfer of the trade or business in which such assets were used.

The determination of whether the taxpayer has retained a substantial interest in the trade or business is to be made immediately after the change in form of conducting the business, as well as after each time the taxpayer disposes of a portion of his interest in the new enterprise. However, in any case where a taxpayer's interest in the business of the new enterprise remains constant in relation to his former interest, the taxpayer will be considered as having retained a substantial interest in the trade or business. Thus, where a taxpayer owns a 5-percent interest in a partnership, and after the incorporation of that partnership the taxpayer retains a 5-percent interest in the corporation, the taxpayer will be considered as having retained a substantial interest in the trade or business as of the date of the change in form.

The provisions of section 47(b) may be illustrated by the following examples:

Example 1.—On July 1, 1962, the XYZ partnership acquires and places in service asset A, a new section 38 asset, with a basis of $30,000

and an estimated useful life of 8 years. One-third of the basis of such asset is taken into account by each of the three partners of the XYZ partnership in computing their individual credits. On January 1, 1964, the XYZ partnership transfers all of its assets to the XYZ corporation, a newly formed corporation, in exchange for all of the stock of XYZ corporation. Such stock is then transferred pro rata to the partners. The XYZ corporation continues to operate the same trade or business formerly conducted as a partnership. On September 1, 1970, the XYZ corporation sells asset A. Assuming all the partners have continuously retained a substantial interest in the XYZ corporation and asset A was used in the business as a section 38 asset until September 1, 1970, no adjustment is required under section 47 since the total holding period of asset A for each partner exceeds 8 years (18 months while used by the XYZ partnership and 80 months while used by the XYZ corporation or a total of 8 years and 2 months).

Example 2.—On January 1, 1963, the X corporation acquires and places in service a new section 38 property (with an estimated useful life of 6 years) which it takes into account in computing a credit. Such property is used in X's manufacturing business. X corporation is also engaged in a separate personal service business. In 1964, the X corporation transfers the assets of the manufacturing business (including the sec. 38 property upon which the X corporation took a credit) to a newly formed corporation, the Y corporation. X corporation then transfers to its shareholders all of the stock of the Y corporation. Since the X corporation does not retain a substantial interest in the manufacturing business, section 47(a) will apply to the transfer of the assets to Y corporation.

(c) *Special rule.*—Subsection (c) of section 47 provides a special rule for treating the increase in tax resulting from the adjustment of the credit. In general, such increase in tax will be treated as a tax imposed by chapter 1. However, it will not be so treated for purposes of determining the amount of the credits under section 33 (relating to tax of foreign countries and possessions of the United States), section 34 (relating to dividends received by individuals), section 35 (relating to partially tax-exempt interest received by individuals), section 37 (relating to retirement income), and section 38 (relating to investment in certain depreciable property). Thus, the increase in tax is not to be taken into account in determining a taxpayer's liability for tax as defined in section 46(a)(3), and hence will have no effect on the limitation contained in section 46(a)(2). However, all adjustments to credit carryovers to the current taxable year resulting from a cessation or change in use during such taxable year are to be taken into account in determining the amount of credit carryovers which may be used for such year.

SECTION 48. DEFINITIONS; SPECIAL RULES

(a) *Section 38 property.*—Section 48 contains various definitions and special rules necessary to the application of the investment credit. Section 48(a) defines the type of property investment which will qualify for the credit.

In general

The term "section 38 property" is defined by section 48(a)(1) as property which is tangible personal property, or which is other tangible property (not including a building and its structural com-

ponents) but only if such other property is used as an integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or is a research or storage facility used in connection with any of the foregoing activities. The property described above, however, must be property with respect to which depreciation (or amortization in lieu of depreciation) is allowable, and such property must have a useful life of 4 years or more (determined as of the time such property is placed in service). (See the discussion of useful life in this report under sec. 46(c), relating to qualified investment.)

If an asset is in part subject to an allowance for depreciation and in part nondepreciable, only the proportionate part of the asset which is subject to depreciation will qualify as section 38 property. Thus, if an asset is used 80 percent of the time in a trade or business and is used 20 percent of the time for personal purposes, only 80 percent of such property will qualify as section 38 property subject to depreciation. Further, property does not qualify to the extent it is treated as property which is used for personal, living, and family purposes under section 274 (relating to disallowance of certain entertainment, etc., expenses).

Property may qualify as section 38 property if amortization is allowable with respect to such property in lieu of depreciation. Amortization in lieu of depreciation is allowable, for example, if a lessee makes improvements on leased property which have a longer estimated useful life than the remaining term of the lease and amortizes the cost of such improvements over the remaining term of the lease.

Tangible personal property may qualify as section 38 property irrespective of whether it is used as an integral part of manufacturing, production, or extraction or of the furnishing of transportation, communications, electrical energy, gas, water, or sewage disposal services. Local law definitions will not be controlling for purposes of determining the meaning of the term "tangible personal property." For purposes of section 48, the term "tangible personal property" includes any tangible property except land, and improvements thereto, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures). Assets accessory to the operation of a business, such as machinery, printing presses, transportation or office equipment, refrigerators, individual air-conditioning units, grocery counters, testing equipment, display racks and shelves, etc., generally constitute tangible personal property for purposes of section 48, even though such assets may be termed fixtures under local law. Further, assets in the nature of machinery will be considered "tangible personal property" for purposes of section 48 whether they are placed within or without a building or other structure. Thus, for example, a gasoline pump, or a hydraulic car lift, although not within any structure, will nevertheless be considered "tangible personal property." Intangible property, such as patents and copyrights, does not qualify as section 38 property.

Buildings and structural components thereof are not eligible for the credit. The term "building" is to be given its commonly accepted meaning, that is, a structure or edifice enclosing a space within its walls, and usually covered by a roof. It is the basic structure of an improvement to land the purpose of which is, for example, to provide shelter or housing or to provide working, office, display, or sales space.

The term would include, for example, the basic structure used as a factory, office building, warehouse, theater, railway or bus station, gymnasium, or clubhouse. The term "structural components" of a building includes such parts of the building as central air-conditioning and heating systems, plumbing, and electric wiring and lighting fixtures, relating to the operation and maintenance of the building.

In addition to tangible personal property, other tangible property (not including a building and its structural components) used as an integral part of the manufacturing, production, or extraction process or as an integral part of a system of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services may qualify for the credit. Property is to be considered as being used as an integral part of a system of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services only if such property is used by one engaged in the trade or business of furnishing such services. Thus, if a manufacturing firm constructs an airstrip for use by airplanes operated for the convenience of its officers and employees, such airstrip would not qualify as section 38 property since the manufacturing firm is not engaged in the transportation business.

The terms "manufacturing," "production," "extraction," and the businesses of furnishing "transportation," "communications," "electrical energy," "gas," "water," or "sewage disposal" services are to be given their commonly accepted meaning. Thus, for example, manufacturing or production includes the construction, reconstruction, or making of property from or with scrap, salvage, or junk material, as well as from new or raw material, (1) by processing, manipulating, refining, or changing the form of an article, or (2) by combining or assembling two or more articles, and includes the cultivation of the soil and the raising of livestock and other farm produce. Section 38 property would include, for example, property used as an integral part of the extraction, processing, refining, and fabrication of minerals or mineral products; the growing, raising, processing, and packing or packaging of foodstuffs; the operation of sawmills and the production of lumber and lumber products and other building materials; and the manufacture, treatment, and packaging of textiles, paper, leather goods, glass, etc. Examples of transportation businesses would be railroads and airlines. Examples of communications businesses would include businesses furnishing telephone and telegraph services or radio or television broadcasting stations.

In order to qualify for the credit, property (other than tangible personal property and research or storage facilities used in connection with the specified activities) must be used as an integral part of one or more of the specified activities. Thus, for example, section 38 property would ordinarily not include such assets as pavements, parking areas, advertising displays, outdoor lighting facilities, or swimming pools which, although used as a part of the overall business operation, are not used directly in the specified activities. Specific examples of qualifying property which normally would be used as an integral part of one of the specified activities are blast furnaces, oil and gas pipelines, and railroad tracks and signals. Fences will qualify as section 38 property where used as an integral part of a specified activity as, for example, where used in connection with the raising of livestock.

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Research or storage facilities (other than buildings) are eligible for the credit if used in connection with any of the specified activities, although such property is not an integral part of the activity. Examples of such facilities include wind tunnels and test stands.

Property used outside the United States

Subparagraph (A) of section 48(a)(2) provides that, subject to certain exceptions contained in subparagraph (B) of that section, the term "section 38 property" does not include property used predominantly outside the United States (as defined in sec. 7701(a)(9)). The term "predominantly outside the United States" means that the property must be physically located outside the United States more than 50 percent of the time during any one taxable year. Thus, if property is originally placed in service in the United States and a credit is received on such property, but such property is thereafter in any one year used predominantly outside the United States, such property ceases to be section 38 property with respect to the taxpayer who obtained the credit, regardless of the fact that the property is later returned to the United States. Furthermore, if property is originally placed in service by the taxpayer outside the United States and is used predominantly outside the United States during the taxable year originally placed in service, such property cannot qualify as section 38 property with respect to such taxpayer.

Subparagraph (B)(i) of section 48(a)(2) provides that any aircraft which is registered by the Administrator of the Federal Aviation Agency and which is operated, whether on a scheduled or nonscheduled basis, to and from the United States may be section 38 property even though it is used predominantly outside the United States. The term "to and from" the United States is not intended to exclude an aircraft which makes flights from one point in a foreign country to another such point, as long as such aircraft returns to the United States with some degree of frequency.

Subparagraph (B)(ii) provides that rolling stock of a domestic railroad corporation subject to part I of the Interstate Commerce Act which is used within and without the United States does not lose its eligibility for the credit even though it is used predominantly outside the United States. For the purposes of subparagraph (B)(ii) the term "rolling stock" means locomotives, freight and passenger train cars, floating equipment, and miscellaneous transportation equipment on wheels, the expenditures for which are chargeable to the equipment investment accounts in the uniform system of accounts for railroad companies prescribed by the Interstate Commerce Commission.

Subparagraph (B)(iii) provides that any vessel which is documented under the laws of the United States and which is operated in the foreign or domestic commerce of the United States may qualify as section 38 property.

Subparagraph (B)(iv) provides that any motor vehicle of a U.S. person (as defined in sec. 7701(a)(30)) which is operated to and from the United States with some degree of frequency may be section 38 property even though predominantly used outside the United States.

Subparagraph (B)(v) provides that any container of a U.S. person which is used in the transportation of property to and from the United States may be section 38 property even though used predominantly outside the United States.

Subparagraph (B)(vi) provides that property (other than vessels or aircraft) of a U.S. person which is used for the purposes of exploring for, developing, removing, or transporting resources from the outer Continental Shelf of the United States (within the meaning of sec. 2 of the Outer Continental Shelf Lands Act, as amended and supplemented; 43 U.S.C., sec. 1331) may be section 38 property. Thus, for example, the credit may be allowed for offshore drilling equipment.

Property used for lodging

The first sentence of paragraph (3) of section 48(a) provides that the term "section 38 property" does not include property which is used predominantly to furnish lodging or is used predominantly in connection with the furnishing of lodging. Thus, if property is used predominantly to furnish lodging in the year it is placed in service, it does not qualify as section 38 property. If property on which a credit has been allowed is used predominantly to furnish lodging in any subsequent year, such property will cease to be section 38 property. Property which is generally considered to be used to furnish lodging includes beds and other furniture and fixtures used in the accommodations for lodging.

The second sentence of section 48(a)(3) provides two exceptions to the rule excluding from the credit property used for lodging or in connection with the furnishing of lodging. Subparagraph (A) of such second sentence provides that nonlodging commercial facilities which are available to persons not using the lodging facilities on the same basis that they are available to persons using the lodging facilities may qualify for the credit. For example, tangible personal property used in a restaurant or pharmacy may qualify as section 38 property notwithstanding the fact that the restaurant or pharmacy is operated in connection with lodging facilities such as an apartment house. However, the furniture and fixtures, rugs, draperies, etc., used, for example, in the lobby of an apartment house would be excluded since they are furnished in connection with the furnishing of lodging and since the lobby of an apartment house is not a nonlodging commercial facility.

Subparagraph (B) of the second sentence of section 48(a)(3) provides that property used by a hotel or motel in connection with the trade or business of furnishing lodging may qualify for the credit where the predominant portion of the accommodations is used by transients. Thus, if more than half of the rooms used to accommodate guests of a hotel or motel are normally used on a transient basis, the property used in such hotel or motel may qualify for the credit even though it is used in connection with furnishing lodging. Conversely, if less than half of the accommodations are normally used on a transient basis, none of the property used in the hotel or motel may qualify for the credit except for property used in connection with a nonlodging commercial facility.

Property used by tax-exempt organizations

Paragraph (4) of section 48(a) provides that property used by an organization (other than a cooperative described in sec. 521) which is exempt from the tax imposed by chapter 1 of the code shall be treated as section 38 property only if such property is used predominantly in an unrelated trade or business the income of which is subject to tax under section 511. The term "property used by" an

organization exempt from tax includes property leased to such an organization, as well as property leased by such an organization to another person. Thus, if property does not qualify under section 48(a)(4) because it is leased to an organization exempt from tax, no credit is allowable to the lessor with respect to such property.

Property used by governmental units

Paragraph (5) of section 48(a) also excludes from the term "section 38 property" property used by the United States, any State (as defined in sec. 7701(a)(10) of the code) or political subdivision thereof, any international organization (as defined in sec. 7701(a)(18) of the code), or any agency or instrumentality of any of the foregoing.

Livestock

Paragraph (6) of section 48(a) which was added by your committee provides that livestock will not be treated as section 38 property. The term "livestock" includes horses, cattle, poultry, and fur-bearing animals, irrespective of the use to which they are put or the purpose for which they are held.

(b) *New section 38 property.*—Subsection (b) of section 48 provides that, for purposes of the credit, "new section 38 property" means only section 38 property, the construction, reconstruction, or erection of which is completed by the taxpayer after June 30, 1962, or acquired by the taxpayer after that date, provided the original use of such property commences with the taxpayer and commences after such date. In the case of property constructed, reconstructed, or erected by the taxpayer, there is to be taken into account in determining the basis of such property only that portion of the basis which is properly attributable to construction, reconstruction, or erection after June 30, 1962. The principles applicable under section 167(c) of the code are to be applied under section 48(b) in determining, for example, when the property is acquired by the taxpayer, whether the original use of the property commences with the taxpayer, and the portion of the basis of property completed after June 30, 1962, which is attributable to construction, reconstruction, or erection after that date.

(c) *Used section 38 property.*—Paragraph (1) of section 48(c) defines the term "used section 38 property" as section 38 property acquired by purchase after June 30, 1962, which is not new section 38 property.

Used section 38 property does not include property which, after its acquisition by the taxpayer, is used by a person who used such property before such acquisition. This rule also applies where the property after acquisition by the taxpayer is used by a person who is related to a person who used the property before acquisition. Such person will be considered as related if the relationship is one described in section 179(d)(2) (A) or (B) (as, for example, where the parties are members of an affiliated group, as defined in sec. 48(c)(3)(C)). Thus, if property were sold under a sale and leaseback arrangement, such property in the hands of the purchaser-lessor would not be used section 38 property since the property, after its acquisition, is being used by the same person who used it before the acquisition. Similarly, where a taxpayer has been leasing property, and subsequently purchases such property (whether or not the lease contained a purchase option feature), such property is not used section 38 property with respect to such taxpayer, since it is being used by the person who used

such property before its acquisition. In addition, if property owned by a lessor is sold subject to a lease or is sold upon the termination of a lease, the property will not qualify as used section 38 property with respect to the purchaser, if thereafter the property is used by a lessee who used the property before the acquisition. For purposes of applying the rule contained in section 48(c)(1), property will be considered used by a person only if a substantial use is made. Thus, property would not be disqualified as used section 38 property merely because a person using the property after acquisition had also made some casual use of it before acquisition.

Dollar limitation

Under subparagraph (A) of section 48(c)(2), the cost of used section 38 property which may be taken into account under section 46(c)(1)(B) in computing qualified investment for any taxable year is not to exceed $50,000. If the total cost of used section 38 property placed in service during the taxable year exceeds $50,000, the taxpayer must select the particular assets he wishes to be taken into account in computing qualified investment (but not to exceed an aggregate cost of $50,000). The selection of the specific assets to be taken into account is to be made at the time and in the manner prescribed by regulations. Such selection may be changed only in the manner and to the extent provided by the regulations. Thus, if a taxpayer has a cost of used section 38 property of $25,000 acquired in connection with the operation of a sole proprietorship, $30,000 allocated to him from a subchapter S corporation, and $20,000 which is his share of the cost of used section 38 property acquired by a partnership of which he is a member, he may select from the total of $75,000 the particular assets which he wishes to take into account for purposes of computing qualified investment. If the assets selected all have useful lives of between 4 and 6 years, the maximum qualified investment in used section 38 property will be $16,667. If the assets selected all have useful lives in excess of 8 years, qualified investment in used section 38 property would be $50,000.

Subparagraph (B) of section 48(c)(2) provides that in the case of a husband or wife filing a separate return, the cost of used section 38 property that may be taken into account is not to exceed $25,000. If this subparagraph applies, and such cost exceeds $25,000, the husband or wife may select, under regulations prescribed by the Secretary of the Treasury or his delegate, the assets to be taken into account, but only to the extent of an aggregate cost of $25,000. Subparagraph (B) shall apply, however, only if the spouse of the taxpayer has purchased (or has been allocated) used section 38 property which may be taken into account in qualified investment for the taxable year of such spouse which ends within or with the taxpayer's taxable year. Thus, if both husband and wife have purchased (or have been allocated) any used section 38 assets for the taxable year (as described above) and they file separate returns, the maximum cost of used section 38 property which may be taken into account by each is $25,000; but if only one spouse has purchased (or has been allocated) any used section 38 assets, such spouse may take into account $50,000 of the cost of used section 38 property.

Subparagraph (C) of section 48(c)(2) provides that in the case of an affiliated group, the $50,000 limitation is to be reduced for each

member of the group by apportioning the $50,000 limitation among the members of the affiliated group in accordance with their respective amounts of used section 38 property which may be taken into account. The phrase, "their respective amounts of used section 38 property which may be taken into account", has reference to the total cost of used section 38 property without regard to the $50,000 limitation or the applicable percentages to be applied in computing qualified investment. An affiliated group is one defined in section 1504(a) except that the phrase "more than 50 percent" is to be substituted for the phrase "at least 80 percent" each place it appears in section 1504 (a), and all corporations are to be treated as includible corporations. Thus, even if a corporation is excluded under section 1504(b) from being a member of an affiliated group for purposes of filing a consolidated return, it nevertheless will be treated as an includible corporation for purposes of section 48(c).

Subparagraph (D) of section 48(c)(2) provides that, in the case of partnerships, the limitation on the amount of used section 38 property which may be taken into account is to apply both with respect to the partnership and with respect to each partner. Thus, a partnership will be limited to used section 38 property having a cost of $50,000 regardless of the number of partners.

If the aggregate cost of used section 38 property purchased by the partnership during a taxable year exceeds $50,000, the partnership, under regulations prescribed by the Secretary of the Treasury or his delegate, is to select the properties, the cost of which is to be taken into account by the partners. Each partner will then combine his share of the cost of the used section 38 property selected by the partnership with the cost of any other used section 38 property to which he may be entitled. This combined amount may not exceed $50,000 (or $25,000 in the case of certain married individuals under section 48(c)(2)(B)). If such amount exceeds $50,000, the taxpayer will then select the properties to which the applicable percentages are to be applied in computing his qualified investment.

Definitions

Subparagraph (A) of section 48(c)(3) provides that the principles of section 179(d)(2) of the code are to be applied in determining whether the property has been acquired by purchase. Thus, for example, used section 38 property is not acquired by purchase if it is acquired from a person whose relationship to the person acquiring it would result in the disallowance of a loss under section 267 or 707(b) (except that in applying sec. 267 (b) and (c), the family of an individual includes only his spouse, ancestors, and lineal descendants, and not his brothers and sisters). Furthermore, the term "purchase" does not include the acquisition of property by one member of an affiliated group (as defined in sec. 48(c)(3)(C)) from another member of the same affiliated group, or the acquisition of property the basis of which is determined in whole or in part by reference to the adjusted basis in the hands of person from whom acquired, or under 1014(a) (relating to property acquired from a decedent).

Subparagraph (B) of section 48(c)(3) provides that the cost of used section 38 property does not include so much of the basis of such property as is determined by reference to the adjusted basis of other property held at any time by the person acquiring such property. Thus, for example, if the basis of used section 38 property acquired is

determined under section 1031 (relating to certain nontaxable exchanges), the preceding rule applies. In addition, if property is disposed of (other than by reason of its destruction or damage by fire, storm, shipwreck, or other casualty, or its theft) and used section 38 property which is similar or related in service or use is acquired as a replacement therefor (whether before or after the disposition), in a transaction to which the preceding rule does not apply, the cost of the used section 38 property acquired is the basis of such property, reduced by the adjusted basis of the property replaced. In such a case, if the basis of the replacement asset is $2,000 and the adjusted basis of the replaced asset is $1,200 at the time of its disposition, the cost of used section 38 property would be $800. Notwithstanding the rules described in this paragraph, the cost of used section 38 property is not to be reduced by the adjusted basis of any property disposed of if by reason of section 47 the disposition of such property gives rise to an increase of tax or a reduction of unused credit carrybacks or carryovers. The cost of used section 38 property acquired as a replacement for property which is destroyed or damaged by fire, storm, shipwreck, or other casualty, or which is stolen, shall be determined under section 46(c)(4).

(d) *Certain leased property.*—Subsection (d) of section 48 provides that in certain cases where property is leased, the lessor may elect to treat the lessee as having acquired such property. This rule applies only with respect to property which is new section 38 property in the hands of the lessor. Thus, for example, the election may not be made with respect to property owned by an organization exempt from tax unless the property is used predominantly in an unrelated trade or business, the income of which is subject to tax under section 511.

In addition, the election may be made only with respect to the first lessee of such new section 38 property, and only if such property would constitute new section 38 property if such lessee had actually acquired the property. Thus, for example, the election cannot be made if the first lessee uses the property predominantly outside the United States.

Also, for purposes of determining whether such property would constitute new section 38 property if purchased by the lessee, the original use of the property will be deemed to commence with the first lessee if he is the first person to use such property for its intended function. Thus, the fact that the lessor may have, for example, tested, stored, or attempted to lease the property to other persons will not preclude the lessee from being deemed the original user as long as neither the lessor nor any other person has physically used the property for its intended function before its use by the lessee. Moreover, in determining whether the property qualifies as new section 38 property to the lessee and in determining the amount of his qualified investment with respect to such property, the estimated useful life of the property to the lessee will be deemed to be the estimated useful life in the hands of the lessor. The election is not available if the lessor is a person referred to in section 46(d); i.e., a mutual savings bank, cooperative bank, or domestic building and loan association to which section 593 applies; a regulated investment company or real estate investment trust subject to taxation under subchapter M; or a cooperative organization described in section 1381(a).

If the election is made, the lessee will be treated for all purposes of subpart B as though he had acquired the property. Thus, if the leased

property is disposed of by the lessee, or if it otherwise ceases to be section 38 property to him, such property will be subject to the provisions of section 47 applicable to such cessations. Also, if the first lessee of property is treated as having acquired such property, the lessor is thereafter precluded from obtaining a credit as to such property. The election under section 48(d) will be made at such time, in such manner, and subject to such conditions as may be provided in regulations prescribed by the Secretary of the Treasury or his delegate.

In any case in which the lessee is treated as having acquired the property, the lessee's investment is deemed to be equal to the fair market value of the property if such property is constructed by the lessor or by a corporation which controls or is controlled by the lessor within the meaning of section 368(c). In any other case the lessee's investment is the basis of the property in the hands of the lessor.

A new sentence has been added to the provisions of section 48(d) as contained in the House bill. This sentence provides that if a lessor makes the election under section 48(d) in respect of any property, then under regulations prescribed by the Secretary of the Treasury or his delegate, section 48(g) shall not apply with respect to such property, and the deductions otherwise allowable to the lessee for amounts paid to the lessor under the lease will be adjusted in a manner consistent with the provisions of section 48(g). Thus, rather than the lessor being required to reduce the basis of the property in respect of which he has elected to treat the lessee as a purchaser, the lessee will be required to reduce the amount of his deductions for rental payments (over a period of time, as provided by regulations) by an amount equal to the credit (determined without regard to the limitation contained in sec. 46(a)(2)).

If, because of a credit or unused credit, a lessee's rental deductions have been reduced, and such credit or unused credit is later reduced because of the application of section 47(a), then an adjustment to the lessee's rental deductions shall be made (in a manner consistent with sec. 48(g)(2) and under regulations prescribed by the Secretary of the Treasury or his delegate) to the extent of the prior diminution of rental deductions attributable to such credit or unused credit.

The provisions of section 48(d) may be illustrated by the following example:

X corporation is engaged in the business of manufacturing and leasing new and reconditioned equipment which in its hands has an estimated useful life of 8 years. After December 31, 1962, X corporation constructs machine No. 1, having a fair market value of $15,000 and a cost of $10,000, and reconditions machine No. 2 at a cost of $5,000. Y corporation leases both machines from X immediately after their construction and reconditioning and before X has made any other use of such machines. As to machine No. 1, if X elects to treat the property as being acquired by Y, such machine will have a basis of $15,000 in Y's hands, and an estimated useful life of 8 years, for purposes of determining qualified investment (assuming the property otherwise qualifies as new sec. 38 property in Y's hands). Y's rental deductions will be reduced (in the manner prescribed by regulations) by an aggregate amount equal to the credit attributable to such property, $1,050 (7 percent times basis of $15,000). The election is not available with respect to machine No. 2, since a reconditioned machine would not constitute new section 38 property if the lessee had purchased it. In such a case, while X corporation cannot make

the election to let the Y corporation take the credit, X corporation would be entitled to a credit based on its expenditure of $5,000 as an investment in new section 38 property, the reconstruction of which is completed after December 31, 1962.

(e) *Subchapter S corporations.*—Subsection (e) of section 48 provides for the application of the credit in the case of an electing small business corporation under subchapter S. The qualified investment of the subchapter S corporation is allocated pro rata among the persons who are shareholders on the last day of the corporation's taxable year. The qualified investment is ascertained at the corporate level, and thus the aggregate cost of used section 38 property that may be allocated to the shareholders is limited to $50,000. If the cost of used section 38 property purchased by the subchapter S corporation exceeds $50,000 in any one taxable year, the corporation is to select, under regulations prescribed by the Secretary of the Treasury or his delegate, the properties the cost of which may be taken into account by its shareholders.

Any person to whom an investment is apportioned under subsection (e) of section 48 is to be treated as the taxpayer with respect to such investment, and such investment will not (by reason of such apportionment) lose its character in his hands as an investment in either new or used section 38 property. Thus, each shareholder will take into account, in determining his own qualified investment, his allocated share of the corporation's qualified investment in new section 38 property. He will also take into account his allocated share of the corporation's investment in used section 38 property. Of course, since only $50,000 cost of used section 38 property may be taken into account, if a shareholder's combined cost of used section 38 property exceeds $50,000, he must select the properties to be taken into account in computing his qualified investment.

If a shareholder includes in his qualified investment any portion of the basis or cost of property acquired by the subchapter S corporation and the corporation subsequently disposes of such property, or if the shareholder disposes of his stock in such corporation, the shareholder will be subject to the provisions of section 47 with respect to such property.

(f) *Estates and trusts.*—Subsection (f) of section 48 provides rules for applying the investment credit to estates and trusts. Paragraph (1) of section 48(f) provides that the qualified investment for any taxable year is to be apportioned between the estate or trust and the beneficiaries on the basis of the income of the estate or trust allocable to each. The qualified investment is ascertained at the trust or estate level, and thus the aggregate cost of used section 38 property that may be apportioned between the estate or trust and the beneficiaries is limited to $50,000. If the cost of used section 38 property purchased by the estate or trust exceeds $50,000 in any one taxable year, the estate or trust is to select, under regulations prescribed by the Secretary of the Treasury or his delegate, the properties the cost of which may be taken into account.

Paragraph (2) of section 48(f) provides that any beneficiary to whom the investment is apportioned is to be treated as the taxpayer with respect to such investment, and such investment will not (by reason of such apportionment) lose its character as an investment in either new or used section 38 property. If the combined cost of used section 38 property available from all sources to any beneficiary

exceeds $50,000, such beneficiary must select the properties the cost of which is to be taken into account in computing his qualified investment. The term "beneficiaries" as used in section 48(f) includes heirs, legatees, and devisees.

Paragraph (3) of section 48(f) provides that the $25,000 amount specified under subparagraphs (A) and (B) of section 46(a)(2) applicable to such estate or trust is to be reduced to an amount which bears the same ratio to $25,000 as the amount of the qualified investment allocated to the estate or trust under paragraph (1) of section 48(f) bears to the entire amount of the qualified investment. Thus, in a case where the qualified investment of the estate or trust is $1 million, and $250,000 of such amount is allocated to the estate or trust because 25 percent of the income is allocable to the estate or trust, the $25,000 amount in the case of such estate or trust is reduced to $6,250.

(g) *Adjustments to basis of property.*—Subsection (g) of section 48 was added to the bill by your committee. Paragraph (1) of section 48(g) provides the general rule that the basis of any section 38 property shall (for purposes of subtitle A, relating to income tax, other than for purposes of new subpart B of pt. IV of subch. A of ch. 1) be reduced by an amount equal to 7 percent of the qualified investment of such property as determined under section 46(c). Thus, an adjustment to basis must be made even though the limitation under section 46(a)(2) reduces the amount of the credit the taxpayer may take into account. Such reduction in basis shall be made before any depreciation deductions are computed. It shall also be taken into account for purposes of determining gain or loss on the sale or disposition of the property, and for any other purpose for which the determination of basis is relevant, except that such adjustment shall be disregarded for purposes of computing (or recomputing) the credit under section 38. No adjustment to basis shall be made in the case of property with respect to which an election under section 48(d) (election of lessor to treat lessee as having acquired the property) has been made. (See sec. 48(d).) If the cost of used section 38 property for any taxable year exceeds $50,000, the basis of only those assets selected to be taken into account under section 46(c)(1)(B) shall be adjusted.

Paragraph (2) of section 48(g) provides that if the tax under chapter 1 of the code is increased for any taxable year under paragraphs (1) or (2) of section 47(a) (relating to certain dispositions, etc., of sec. 38 property) or an adjustment in carrybacks or carryovers is made under paragraph (3) of such section, the basis of the property described in section 47(a) (1) or (2) shall be increased by an amount equal to the portion of the increase in tax and adjustments to carrybacks or carryovers attributable to such property. Whenever the preceding sentence applies, the increase in the basis of the property shall be made immediately before the event causing the application of section 47(a) (1) or (2). Thus, the adjustment will be taken into account for purposes of determining gain or loss on a disposition of the property. (In the case of property subject to an election under section 48(d), see sec. 48(d).)

The provisions of paragraphs (1) and (2) of section 48(g) may be illustrated by the following example:

Corporation X acquires and places in service a new section 38 asset on January 1, 1964, the first day of its first taxable year. Such asset has a basis of $60,000 and an estimated useful life of 10 years. Cor-

poration X's credit is $4,200 (7 percent times $60,000, qualified investment), but since X's liability for tax (as defined in sec. 46(a)(3)) is only $4,000, X can only take into account $4,000 of its credit. X will have an unused credit carryover of $200. However, X must reduce the $60,000 basis of its section 38 asset by the full $4,200 credit. The basis of such section 38 asset for purposes of computing a depreciation allowance for the year ending December 31, 1964, is $55,800 ($60,000 basis less $4,200 credit determined without regard to the limitation of sec. 46(a)(2)). On June 30, 1965, corporation X sells such asset. There will be added to the taxes imposed by chapter 1 for X's taxable year ending December 31, 1965, $4,000 (the aggregate decrease in the credits allowed resulting solely from substituting a 1½-year life for such asset in recomputing qualified investment for 1964). The unused credit carryover to 1965 is reduced from $200 to zero. (See sec. 47(a)(3).) The basis of such asset immediately prior to the sale on June 30 shall be increased by $4,200 ($4,000, the increase in tax, plus $200, the adjustment in carryovers, attributable to the property).

(c) *Deduction for unused credit.*—Subsection (c) of section 2 of the bill was added by your committee. It adds new section 181 to part VI of subchapter B of chapter 1 (relating to itemized deductions for individuals and corporations). Section 181 provides that if the amount of the credit earned (after taking into account any reductions in credit and credit carryovers resulting from the application of sec. 47(a)) exceeds the limitation provided by section 46(a)(2) for any taxable year, and if any portion of such excess credit has not, after the application of section 46(b) (relating to a 3-year carryback and a 5-year carryover of unused credits), been allowed to the taxpayer as a credit under section 38 for any taxable year, then an amount equal to such portion shall be allowed to the taxpayer as a deduction for the first taxable year following the last taxable year in which such portion could under section 46(b) have been allowed as a credit. In the case of property with respect to which an election under section 48(d) has been made, the lessee of such property is the taxpayer and will be entitled to such deduction.

However, if a taxpayer dies or ceases to exist prior to the first taxable year following the normal expiration of an unused credit carryover (5 years), an amount equal to the unused credit, or an amount equal to the proper portion thereof, shall, under regulations prescribed by the Secretary of the Treasury or his delegate, be allowed to the taxpayer as a deduction for the taxable year in which such death or cessation occurs. The preceding rule shall not apply to a corporate acquisition to which new paragraph (23) of section 381(c) applies. A "proper portion" of the unused credit carryover means that a deduction shall be allowed only to the extent that the reduction in basis under section 48(g) (or reduction in lease payments under sec. 48(d)) has caused a diminution of prior depreciation allowances (or rental payments).

The provisions of section 181 may be illustrated by the following examples:

Example 1.—Y corporation's credit based on its investment for the calendar year ending December 31, 1964, its first taxable year, amounts to $100,000, and the limitation under section 46(a)(2) is $60,000. Y's unused credit for 1964 is $40,000 ($100,000 minus

$60,000), which it may carry forward to 1965, and the 4 succeeding taxable years. However, because of successive net operating losses through 1969, Y is unable to use any portion of the $40,000 as a credit against tax; nor has the $40,000 unused credit carryover been adjusted under section 47(a)(3). For the taxable year ending December 31, 1970, Y, in computing its taxable income, may take a deduction for $40,000 under the new section 181.

Example 2.—Corporation X acquires and places in service a new section 38 asset, asset A, on January 1, 1964, the first day of its first taxable year. Asset A has an estimated useful life of 4 years. The credit with respect to such asset is $50,000, but because of the limitation based on tax, only $30,000 is taken into account as a credit in 1964. X has an unused credit carryover of $20,000 which may be carried forward through 1969. Because of substantial purchases of section 38 property in 1965, 1966, 1967, and 1968, X is unable to use any portion of the $20,000 credit carryover as a credit against tax. By 1968, asset A has been fully depreciated. On December 31, 1968, X distributes all of its assets in complete liquidation and dissolves. The transaction is not one to which section 381(c) applies, and section 48(g)(2) does not apply to the transfer of asset A. For the taxable year ending December 31, 1968, X, in computing its taxable income, may take a deduction for $20,000 under section 181.

(d) *Certain corporate acquisitions.*—Subsection (d) of section 2 of the bill, which corresponds to subsection (c) of section 2 of the bill as passed by the House, provides an amendment to section 381(c) of the 1954 Code (relating to the carryover of tax attributes in the case of certain corporate acquisitions) by adding paragraph (23) thereto. Section 381(c)(23) provides that the acquiring corporation is to take into account (to the extent proper to carry out the purposes of sec. 381 and sec. 38, and under such regulations as may be prescribed by the Secretary of the Treasury or his delegate) the items required to be taken into account for purposes of section 38 in respect of the distributor or transferor corporation. Thus, for example, the regulations under section 381(c)(23) will provide rules for the carryover of any unused credit carryovers of the distributor or transferor corporation, for the application of new section 181, and for the application of section 47 to dispositions by the acquiring corporation of property acquired from the distributor or transferor corporation.

(e) *Statutes of limitations and interest relating to investment credit carrybacks.*—Subsection (e) of section 2 of the bill, which was added to the bill by your committee, amends certain provisions of the code relating to statutes of limitations and interest. These amendments were made necessary by the adoption of the provision allowing a 3-year carryback of any unused investment credit.

Paragraph (1) of section 2(e) of the bill amends section 6501, relating to limitations on assessment and collection, to provide that in the case of a deficiency attributable to the application of an investment credit carryback, the deficiency may be assessed at any time before the expiration of the period within which a deficiency may be assessed for the taxable year in which the unused investment credit arose (i.e., the unused credit year) which results in such carryback. This provision in effect suspends the statute of limitations on the assessment of a deficiency on account of the disallowance of an erroneous or improper investment credit carryback until the expiration of

the statutory period of limitation on assessments attributable to the taxable year from which the investment credit carryback arose.

Paragraph (2) of section 2(e) of the bill amends subsection (d) of section 6511, relating to limitations on credit or refund, by adding a new paragraph (4) thereto, entitled "Special period of limitation with respect to investment credit carrybacks." Subparagraph (A) of new paragraph (4) provides that a claim for credit or refund relating to an investment credit carryback may be filed at any time before the 15th day of the 40th month (or 39th month, in the case of a corporation) following the end of the taxable year of the unused investment credit which gave rise to the carryback, or within the period prescribed in section 6511(c) in respect of such year (relating to special rules applicable in case of extension of time by agreement), whichever expires later. Subparagraph (A) of new paragraph (4) also provides that in the case of such a claim, the amount of the credit or refund may exceed the portion of the tax paid within the period provided in section 6511 (b)(2) or (c), depending on whichever is applicable, to the extent of the amount of the overpayment which is attributable to the carryback.

Subparagraph (B) of new paragraph (4) of section 6511(d) provides rules for the application of the special period of limitation with respect to the investment credit carryback. Subparagraph (B) provides that if the allowance of a credit or refund of an overpayment of tax attributable to an investment credit carryback is otherwise prevented by operation of any law or rule of law other than section 7122, relating to compromises, such credit or refund may be allowed or made, if a claim therefore is filed within the period provided in section 6511(d)(4)(A). In the case of any such claim for credit or refund, the determination by any court, including the Tax Court, in any proceeding in which the decision of the court has become final, shall not be conclusive with respect to the investment credit, and the effect of such credit, to the extent that such credit is affected by a carryback which was not an issue in such proceedings.

Paragraph (3) of section 2(e) of the bill amends subsection (e) of section 6601 (relating to interest on underpayment, nonpayment, or extensions of time for payment of tax) to provide that if the credit allowed by section 38 for any taxable year is increased by reason of an investment credit carryback, the increase shall not affect the computation of interest under section 6601 for the period ending with the last day of the taxable year in which the investment credit carryback arises (the unused credit year).

Paragraph (4) of section 2(e) of the bill amends subsection (f) of section 6611, relating to interest on overpayments, to provide that for purposes of the payment of interest on an overpayment of tax resulting from an investment credit carryback, such overpayment will be deemed not to have been made prior to the close of the taxable year in which the investment credit carryback arises. Thus, if an unused investment credit for the calendar year 1968 is carried back to 1965, and an overpayment of tax for the year 1965 results, no interest will be allowed or paid in respect of such overpayment for any period prior to December 31, 1968.

(f) *Technical amendment.*—Subsection (f) of section 2 of the bill, which was added by your committee, amends section 1016(a) of the 1954 Code, relating to adjustments to basis, by adding a new para-

graph 19 thereto. Under the new section 1016(a)(19), an adjustment must be made to the basis of property which is or has been section 38 property, to the extent provided in section 48(g).

(g) *Clerical amendments.*—Subsection (g) of section 2 of the bill, provides a clerical amendment to part IV of of subchapter A and part VI of subchapter B of chapter 1 of the 1954 Code.

(h) *Effective date.*—Subsection (h) of section 2 of the bill provides that the amendments made by section 2 of the bill are to apply with respect to taxable years ending after June 30, 1962.

SECTION 3. APPEARANCES, ETC., WITH RESPECT TO LEGISLATION

Except for the addition by your committee of a provision relating to stockholders and employees, this section is identical to section 3 of the bill as passed by the House. Subsection (a) of section 3 amends section 162 (relating to trade or business expenses) by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) a new subsection (e) relating to appearances, etc., with respect to legislation.

Paragraph (1) of the new subsection (e) provides that the deduction allowed by subsection (a) of section 162 is to include all of the following ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business: (1) expenses in direct connection with appearances before, submission of statements to, or sending communications to, the committees, or individual members, of Federal, State, or local legislative bodies with respect to legislation or proposed legislation of direct interest to the taxpayer, (2) expenses in direct connection with communication of information between the taxpayer and an organization of which he is a member with respect to legislation or proposed legislation of direct interest to the taxpayer and to such organization, (3) that portion of dues with respect to any organization of which the taxpayer is a member which is attributable to the expenses of the activities above described in this paragraph which are carried on by such organization, and (4) expenses in direct connection with communication of information between the taxpayer and an employee or stockholder with respect to legislation or proposed legislation of direct interest to the taxpayer. Paragraph (1) also provides that the expenses referred to therein are to include, but not be limited to, the cost of preparing testimony and traveling expenses described in subsection (a)(2) of section 162.

Paragraph (2) of the new subsection (e) provides that the provisions of paragraph (1) are not to be construed as allowing the deduction of any amount paid or incurred (whether by way of contribution, gift, or otherwise)—

(1) for participation in, or intervention in, any political campaign on behalf of any candidate for public office, or

(2) in connection with any attempt to influence the general public, or segments thereof, with respect to legislative matters, elections, or referendums.

Subsection (b) of this section of the bill provides that the amendments made by subsection (a) are to apply to taxable years beginning after December 31, 1962.

SECTION 4. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES

(a) *Denial of deduction.*—Subsection (a) of section 4 of the bill adds to part IX of subchapter B of chapter 1 of the code (relating to items not deductible in computing taxable income) a new section 274.

SECTION 274. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES

Section 274 provides generally that certain expenses deductible in full under present law will be partially or completely disallowed for purposes of chapter 1 of subtitle A. Since section 274 is a disallowance provision exclusively, no expense would become deductible by reason of its enactment. In other words, the tests for deductibility under provisions of existing law (such as secs. 162, 165, 167, and 212) must first be met before the provisions of section 274 become operative. In addition, subsection (d) (relating to substantiation) of the new section 274 must be applied before determining the extent to which an expense or other item is disallowed under subsection (a), (b), or (c) of section 274.

(a) *Entertainment, amusement, or recreation.*—

Activity.—Paragraph (1)(A) of subsection (a) of new section 274 provides that no deduction otherwise allowable under chapter 1 of the 1954 Code is to be allowed for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes that the item was directly related to or associated with the active conduct of his trade or business. Such deduction in no event is to exceed the portion of such item directly related to or associated with the active conduct of the taxpayer's trade or business.

Examples of "entertainment, amusement, or recreation" are entertaining guests at nightclubs, country clubs, theaters, football games, and prizefights, and on hunting, fishing, vacation, and similar trips. In addition, "entertainment" includes satisfying the personal, living, or family needs of any individual (which would otherwise constitute a business expense to the taxpayer) such as the furnishing of food and beverages, a hotel suite, or an automobile. By referring to an activity which "is of a type generally considered to constitute" entertainment, amusement, or recreation, the subsection provides an objective test for determining whether an activity is to be treated under this new provision.

Facilities.—Paragraph (1)(B) of subsection (a) of new section 274 provides that no deduction otherwise allowable under chapter 1 of the code is to be allowed for any item with respect to a facility used in connection with an activity generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes that the facility was used primarily for the furtherance of his trade or business, and that the item was directly related to or associated with the active conduct of his trade or business. Such deduction in no event is to exceed the portion of such item directly related to or associated with the active conduct of the taxpayer's trade or business. The same tests for determining whether an item is directly related to

or associated with the active conduct of a trade or business apply as in the case of an item under paragraph (1)(A).

The term "facility" includes any item of personal or real property owned or rented by the taxpayer, such as a yacht, hunting lodge, fishing camp, swimming pool, tennis court, bowling alley, automobile, airplane, apartment, hotel suite, dining room, and cafeteria. In addition to the items more commonly regarded as "expenses" for entertaining, discussed above, paragraph (1)(B) also relates to other items, such as depreciation and losses realized on certain sales.

Under paragraph (1)(B), in addition to the requirement that the item be directly related to or associated with the active conduct of the taxpayer's trade or business, the facility must be used primarily for the furtherance of the taxpayer's trade or business. Thus, if a facility is used more than one-half for business entertaining, so that more than one-half of the entertainment expense with respect to such facility would be deductible as a business expense under present law, that portion is still to be deductible to the extent it meets the test of being directly related to or associated with the active conduct of the taxpayer's trade or business. If less than one-half of such entertainment expense would be deductible under present law, no deduction is to be allowed.

Paragraph (2) of subsection (a) of new section 274 prescribes two special rules for purposes of applying paragraph (1). All dues and fees paid to any social, athletic, or sporting club or organization will be treated as items with respect to a facility used for entertaining. Thus, only if the taxpayer uses a country club to which he belongs primarily for the furtherance of his business will a deduction be allowed for dues or fees paid to such club, and then only to the extent that such use is directly related to or associated with the active conduct of his business. In addition, in applying paragraph (1) an activity described in section 212 (relating to expenses for the production of income) is to be treated as a trade or business.

(b) *Gifts.*—Subsection (b)(1) of new section 274 is the same as passed by the House except that your committee has added three exceptions to the term "gift." Generally, subsection (b)(1) disallows all expenses for gifts to individuals in excess of a cumulative total of $25 per year per recipient. The reference to "indirect" gifts in this subsection includes situations where the gift is intended for the eventual use or benefit of an individual but is made initially to his corporation or to some member of his family. The term "gift", for purposes of section 274, has, in general, the same meaning as it does under section 102 of the code (relating to the exclusion of gifts and inheritances from gross income).

Any item which is excludable from gross income under a provision of chapter 1 of the code other than section 102 is not a "gift" within the meaning of subsection (b)(1). To illustrate the applicability of subsection (b)(1), a payment by an employer to a deceased employee's widow which is excludable from her income by reason of the gift exclusion provision, section 102, will not be deductible by the employer in excess of $25, whereas the treatment by an employer of a payment to a deceased employee's widow which is not a gift but which constitutes an employee's death benefit excludable by the recipient under section 101(b) of the code will not be affected by this provision. As another example, amounts paid to an individual as a scholarship

which are excludable from the individual's gross income under section 117 of the code are not "gifts" within the meaning of this subsection. Similarly, those prizes and awards which are excludable from a recipient's gross income under section 74(b) of the code are not "gifts" within the meaning of this subsection.

Subparagraph (A) sets forth the first exception to the term "gift" added by your committee. It provides that the term "gift" does not include an item which cost the taxpayer not more than $4 on which the name of the taxpayer is clearly and permanently imprinted and which is one of a number of identical items distributed generally by the taxpayer. Thus, the deductibility of the cost of any such item will not be affected by section 274(b) and the taxpayer will not have to take such items into account in connection with the $25 limitation in such section.

The second exception, in subparagraph (B), excludes from the term "gift" any sign, display rack, or other promotional material to be used on the business premises of the recipient. Such items are sometimes referred to as "point-of-purchase" advertising materials.

Subparagraph (C) contains the third exception to the term "gift" added by your committee. It provides that "gift" does not include an item of tangible personal property, such as a watch, which costs the taxpayer not more than $100 and which the taxpayer awarded to an employee because of his length of service or for his safety achievement. This exception relates only to deductibility by the employer. It is not intended to have any effect in determining whether the employee who receives the award is to be taxed on its value.

Since the question in subsection (b)(1) is what portion of the taxpayer's expense will be disallowed, the $25 amount necessarily relates to the taxpayer's cost rather than to the value of the property to the donee. However, certain incidental costs, such as packaging, insurance, and mailing or other delivery, will be disregarded in determining whether the $25 limit has been exceeded.

There is a possibility of overlapping application of subsections (a) and (b), since some items can reasonably be classified both as gifts and as entertainment. Different rules under section 274 apply depending on the classification of the item. As described in greater detail below, the express authority given to the Secretary of the Treasury or his delegate to prescribe regulations will be used to solve these problems of classification so as to clarify and make more certain the application of section 274.

Subsection (b)(2) prescribes two special rules for applying subsection (b)(1). Under subsection (b)(2)(A), in the case of a gift by a partnership (including a gift made by a partner with respect to the business of the partnership), the $25 limitation will be applied at the partnership level, as well as at the level of the individual partner. Thus, deductions for gifts made with respect to partnership business will not exceed $25 per recipient, regardless of the number of partners.

Under subsection (b)(2)(B), a husband and wife are for purposes of subsection (b)(1) treated as one "taxpayer". Thus, in the case of a gift by a husband and wife, the spouses will be treated as one donor. However, since "taxpayer" in subsection (b)(1) refers only to the donor of a gift, this special rule does not pertain to gifts, for example, made by an individual to a husband and wife who are partners in a business.

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(c) *Traveling.*—This is a new subsection adopted by your committee. Under present law if a taxpayer travels to a destination and while at such destination engages in both business activities (or activities described in section 212) and personal activities, traveling expenses to and from such destination are deductible only if the trip is related primarily to the taxpayer's trade or business. If the primary purpose is business the entire amount of such traveling expenses is deductible. If the trip is primarily personal in nature no part of the traveling expenses to and from the destination is deductible even though the taxpayer engages in business activities while at such destination. However, expenses while at the destination which are properly allocable to the taxpayer's trade or business are deductible even though the traveling expenses to and from the destination are not deductible.

The new subsection (c) which your committee has added to section 274 provides that in the case of any individual who is traveling away from home in pursuit of a trade or business or in pursuit of an activity described in section 212, no deduction shall be allowed under section 162 or section 212 for that portion of the expenses of such travel otherwise allowable under such section which, under regulations prescribed by the Secretary of the Treasury or his delegate, is not allocable to such trade or business or to such activity. Under this provision a taxpayer must meet two tests before he becomes entitled to deduct traveling expenses. First, the expenditure must be deductible under the rules of section 162 or 212. If it is not deductible under those sections the taxpayer gets no deduction and no reference to the rules of section 274(c) is necessary. However, if an expenditure is deductible under section 162 or 212 then the expenditure must be subjected to the allocation rules of section 274(c) to determine the extent to which the expenditure is ultimately deductible.

To avoid the application of section 274(c) in cases where the possibilities of abuse are relatively small your committee's amendment provides that the provision shall not apply to the expenses of any travel away from home which does not exceed 1 week or where the portion of the time away from home which is not attributable to the pursuit of the taxpayer's trade or business or an activity described in section 212 is less than 25 percent of the total time away from home on such travel.

The operation of subsection (c) may be illustrated by the following examples:

Example 1.—Taxpayer A flew from New York to London where he conducted business for 2 days. A then flew to Stockholm for a 14-day vacation after which he flew back to New York from Stockholm. The trip took 18 days, 2 of which were attributable to the flight to London and return. A would not have made the trip except for the business he had to conduct in London. Under present law A could deduct the entire cost attributable to transportation and food to and from London and the food and lodging during the 2 days spent on business in London. The traveling expenses attributable to the vacation part of his trip including transportation, food, and lodging would not be deductible under present law. Such personal expenditures would also not be deductible under section 274(c) in the bill. In addition under such section, since the travel away from home exceeded a week and the time devoted to personal activities was not less than 25 percent of the total time away from home, it is contem-

plated that the regulations will provide that fourteen-eighteenths (14 days devoted to personal activities out of a total of 18 days away from home on the trip) of the costs attributable to transportation and food to and from London are to be disallowed. The deductibility of cost of the food and lodging during the 2 days spent on business in London would be determined under section 162(a)(2), as amended by the bill.

Example 2.—Taxpayer B flew from New York to Paris where he conducted business for 1 day. He spent the next 2 days sightseeing in Paris and then flew back to New York. The entire trip, including 2 days flying to and from Paris, took 5 days. B would not have made the trip except for the business he had to conduct in Paris. Under present law B can deduct the entire cost of his transportation and food to and from Paris, and the food and lodging attributable to the 1 business day in Paris but not the food and lodging attributable to the 2 days spent on sightseeing. Since the trip did not exceed 1 week, the allocation rules of section 274(c) would not apply.

Example 3.—Taxpayer C flew from New York to Brussels where he spent 14 days on business and 5 days on personal matters and then flew back to New York. The entire trip, including 2 flying days, took 21 days. C would not have made the trip except for the business he had to transact in Brussels. Under present law C could deduct the entire cost attributable to transportation and food to and from Brussels and the food and lodging during the 14 days spent on business but not the food and lodging attributable to the 5 days spent on personal matters. Although the trip exceeded a week the time away from home attributable to nonbusiness activities (5 days out of 21) was less than 25 percent of the total time away from home during the trip. Therefore the allocation rule of section 274(c) does not apply.

(d) *Substantiation required.*—This subsection, except for a clerical change, is identical to subsection (c) of section 274 of the bill as passed by the House. It imposes another limitation on traveling expenses deductible under section 162(a)(2) or 212, on items with respect to activities described in subsection (a) as entertainment, amusement, or recreation, or with respect to facilities used in connection therewith (whether or not excepted from the application of subsec. (a) of sec. 274 by subsec. (e)), and on expenses for gifts. Subsection (d) overrules with respect to the described expenditures the case of *Cohan* v. *Commissioner*, 39 F. 2d 540 (C.A. 2d 1930). That case held that where evidence indicates that a taxpayer has incurred deductible travel or entertainment expenses but their exact amount cannot be determined, the court must make "as close an approximation as it can" and not disallow the deduction entirely. Under subsection (d) approximations of the type which under the *Cohan* doctrine have been sufficient to entitle the taxpayer to a deduction will no longer have that effect. In other words, if the taxpayer fails to substantiate an item as required by subsection (d) and the regulations thereunder, the item will be completely disallowed.

Subsection (d) provides that no deduction is to be allowed for the above-described items unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his own statement the following: the amount of such expense or other item; the time and place of the travel, entertainment, amusement, recreation, or use of the facility, or the date and description of the gift; the business purpose

of the expense or other item; and the business relationship to the taxpayer of the persons entertained, using the facility, or receiving the gift. The taxpayer's records or corroborating evidence, must pertain to separate expenses or other items of deduction, not to aggregate amounts.

Generally, a clear, contemporaneously kept diary, account book, or similar record containing the information specified in subsection (d) will be an adequate record within the meaning of this subsection. However, receipts, canceled checks, paid bills, stubs, or other similar records may be required in certain cases, as, for example, to substantiate the amount expended for lodging and transportation while traveling on business. Thus, the taxpayer may be required to preserve hotel bills or transportation receipts to substantiate such items by adequate records. In order to avoid hardship, a reasonable reconstruction of expenditures will be accepted in those cases where the absence of records is due to circumstances beyond the taxpayer's control, such as destruction by fire, flood, or other casualty.

Where the taxpayer fails to maintain adequate records with respect to any of the described aspects of an expense, that aspect must be substantiated by the taxpayer's own statement corroborated by sufficient evidence. The taxpayer's own uncorroborated statement will not constitute substantiation with respect to any such aspect. The evidence required may vary with respect to each aspect of an item claimed as a deduction. Thus, circumstantial evidence, such as the nature of the business activities of the taxpayer and of the person entertained, may be sufficient to corroborate the taxpayer's statement regarding business purpose and business relationship, whereas more direct evidence, such as the testimony of witnesses, will be required to substantiate amount, time, place, date, and description.

Under subsection (d), the Secretary of the Treasury or his delegate is authorized to provide by regulations that some or all of the requirements of subsection (d) are not to apply in the case of an expense which does not exceed an amount determined under such regulations. Thus, the regulations could provide that a fixed scale of allowance for mileage or per diem in lieu of subsistence, based upon reasonable business practices, will be acceptable in lieu of detailed substantiation. Similarly, the regulations could prescribe an exception for *de-minimis* expenses.

(e) *Exceptions to application of subsection (a).*—Subsection (e) of the new section 274 is identical to subsection (d) of the bill as passed by the House except for clerical changes and an amendment to paragraph (6) discussed below. Subsection (e) contains nine exceptions to the general rule of section 274(a). These exceptions are to the disallowance provision of subsection (a) exclusively. The fact that an item is not covered by one of the nine exceptions does not mean that *ipso facto* it will be disallowed under subsection (a). It is to be emphasized that the new section 274(e) in no way changes existing law with respect to the disallowance of expenses by reason of failure to meet the "ordinary and necessary" test in section 162 or 212 of the code. Furthermore, the substantiation requirements of subsection (d) also must be fulfilled with respect to the items covered by these exceptions.

Paragraph (1) excepts from the disallowance prescribed in subsection (a)(1) expenses for food and beverages furnished under circum-

stances which are of a type generally considered to be conducive to a business discussion, taking into account the surroundings in which furnished, the taxpayer's trade, business, or income-producing activity, the relationship to such trade, business, or activity of the persons to whom the food and beverages are furnished, and any other relevant facts. There is no requirement in this exception that business actually be discussed. Thus, if the described circumstances are established, and if the amounts are deductible under section 162 or 212 and are substantiated as required under section 274(d), the expenses for food and beverages will be deductible without reference to the "directly related to or associated with" tests of subsection (a)(1). Of course, "trade or business" is not restricted to commercial activities but includes other activities such as teaching, the practice of law or medicine, etc.

Paragraph (2) relates to food and beverages furnished on the taxpayer's business premises. By reason of this exception, no expense for food and beverages furnished on the business premises primarily to employees of the taxpayer will be disallowed under section 274(a). In addition, expenses for food and beverages furnished to nonemployee business guests will be deductible if furnished in a dining room which is primarily for the taxpayer's employees and is located on the taxpayer's business premises. Paragraph (2) also excepts from disallowance expenses for facilities to the extent they are used in connection with furnishing the above-described food and beverages. The exception provided by paragraph (2) applies to both the typical company cafeteria and meals furnished to employees because their presence on the job at all times is essential.

The exception in paragraph (3) applies to expenses for goods, services and facilities to the extent that the expense is properly treated by the taxpayer, with respect to the recipient of the entertainment, amusement, or recreation, as compensation paid to an employee on the taxpayer's income tax return and as "wages" for purposes of withholding. Thus, a taxpayer rewarding a key employee with a vacation trip would not be disallowed the expenses under section 274(a) if the taxpayer treated the expenses as wages for withholding purposes and deducted them on his income tax return as compensation paid to the key employee. Salary paid to the captain of a yacht used for business entertaining does not come within this exception.

If an expense properly constitutes a dividend to a shareholder, or if it constitutes unreasonable compensation to an officer or employee, the exception in paragraph (3) will not prevent its disallowance.

Paragraph (4) excepts from disallowance with respect to the taxpayer certain expenses paid or incurred by the taxpayer in connection with the performances by him of services for another person (whether or not such other person is the taxpayer's employer) for which the taxpayer is reimbursed by such other person under a reimbursement or other allowance arrangement. This exception prevents the double disallowance of a single expenditure, once with respect to the person who actually bears the expense and benefits from it and once with respect to the person who pays the expense on behalf of the first person and is reimbursed therefor. However, two qualifications are provided which insure that a described expense will be disallowed at one level. If the services are performed by a taxpayer, who is an employee, for his

employer, and if the employer treats the expense as compensation paid to the employee and it falls within the scope of the subsection (e)(3) exception, the subsection (e)(4) exception does not apply. If the services are performed by the taxpayer for a person who is not the taxpayer's employer, the subsection (e)(4) exception does not apply unless the taxpayer accounts to such other person by means of records or other sufficient evidence which would satisfy the substantiation requirement of subsection (d). The term "reimbursement or other expense allowance arrangement" is derived from section 62(2)(A) of the code and has the same meaning in section 274(e) (without regard to whether the taxpayer is the employee of the person for whom services are performed) as it does in that section.

Paragraph (5) provides an exception for expenses for recreational, social, or similar activities which are primarily for the benefit of the employees of the taxpayer. This exception applies to the usual employee fringe benefit programs. For example, the expenses of operating a company bowling alley or swimming pool which is available to all employees generally will be deductible. Similarly, the costs of the office Christmas party or summer outing generally will be deductible.

In order to exclude from this exception benefits primarily for executives and owners of closely held businesses, the exception applies only with respect to activities which are primarily for employees other than employees who are officers, shareholders or other owners who own a 10 percent or greater interest in the business, or highly compensated employees. In determining whether an employee owns a 10 percent or greater interest in the business, the employee is to be treated as owning any interest owned by a member of his family (within the meaning of sec. 267(c)(4)).

Paragraph (6) provides an exception for expenses incurred by a taxpayer which are directly related to business meetings of his employees, stockholders, agents, or directors. This paragraph is substantially the same as paragraph (6) of subsection (d) of section 274 in the bill as passed by the House except that whereas the bill as passed by the House was limited to meetings of employees and stockholders, your committee's amendment also includes meetings of agents and directors of the taxpayer. This exception pertains only to meetings which are principally for the discussion of business. To illustrate, a meeting of employees for the principal purpose of introducing them to and instructing them with respect to a new procedure for conducting the employer's business would be considered a business meeting. Similarly, a regular annual meeting of stockholders for the election of directors and discussion of corporate affairs would be considered a business meeting. A convention of employees for the principal purpose of rewarding them for their outstanding performance of services for their employer would not be considered a business meeting. However, such a convention might come within the scope of paragraph (3) or (5).

Paragraph (7) pertains to expenses directly related and necessary to attendance at business meetings or conventions of exempt section 501(c)(6) organizations. It is similar to the exception in paragraph (6), except that it relates only to attendance at meetings, or conventions of business leagues, chambers of commerce, real estate boards, or boards of trade which are exempt from tax under section 501(a).

Paragraph (8) pertains to goods and services (including the use of facilities) which are made available by the taxpayer to the general public. By reason of this exception, expenses for entertainment of the general public by means of television, radio, newspapers, and the like will continue to be deductible under section 162. Similarly, a deduction may still be claimed under section 162 for the expense of maintaining private parks, golf courses, and similar facilities, to the extent that they are available for public use. For example, if a corporation maintained a swimming pool for the use of its executive officers and their guests, but during the summer months made the pool available for a period of time each week to the children participating in the local public recreation program, the portion of the expenses relating to such public use of the pool would come within this exception.

Paragraph (9) is designed to insure that no expense will be disallowed under subsection (a) if it is for goods or services which are sold by the taxpayer in a bona fide transaction for an adequate and full consideration in money or money's worth. Thus, the cost of producing nightclub entertainment for sale to customers will not be disallowed. Similarly, the cost of operating a pleasure cruise ship as a business will not be disallowed.

The last sentence in subsection (e) makes it clear that the "expenses" to which paragraphs (1) through (9) relate include such items as depreciation and losses.

(f) *Interest, taxes, casualty losses, etc.*—This subsection, except for a clerical change, is identical to subsection (e) of new section 274 of the bill as passed by the House. Subsection (f) excepts from the provisions of section 274 items which would constitute allowable deductions for an individual taxpayer regardless of whether he was engaged in any trade or business. Examples of such items are interest, taxes such as real property taxes, and casualty losses. Thus, if a taxpayer owned a fishing camp, he could still deduct mortgage interest and real property taxes in full even if its use was not primarily for the furtherance of the taxpayer's trade or business.

(g) *Treatment of entertainment, etc., type facility.*—This subsection, except for a clerical change, is identical to subsection (f) of new section 274 of the bill as passed by the House. This subsection prescribes the treatment to be accorded facilities coming within the purview of subsection (a)(1)(B), for purposes of chapter 1 generally. To the extent that expenses and other items with respect to a facility are disallowed under subsection (a), that portion of the facility is to be accorded the treatment provided under present law to an asset used exclusively for personal, living, and family purposes. Thus, the portion of a facility so treated will not be subject to depreciation, and losses incurred on the sale of such portion will not be deductible.

(h) *Regulatory authority.*—This subsection, except for a clerical change, is identical to subsection (g) of new section 274 of the bill as passed by the House. Subsection (h) authorizes the Secretary of the Treasury or his delegate to prescribe such regulations as he deems necessary to carry out the purposes of section 274. For example, under this authorization rules will be prescribed for determining whether subsection (a) or subsection (b) applies to an expenditure to which both subsections might be considered to apply. Items are to be given the character ascribed to them by the public generally and without regard to the revenue consequences of the characterization.

In addition, the Secretary of the Treasury or his delegate is required to prescribe rules for determining whether section 274 (a) or (b) applies with respect to an expenditure which could also be described as falling solely within the purview of some other section. This overlap problem will be resolved by ascribing to the expenditure a character which carries out the purposes of section 274. If the item confers a personal benefit in the form of entertainment, amusement, recreation, or a personal, living, or family need of the individual it will be treated as a section 274 item.

The problem of the overlap of subsections (a) and (b) of section 274 can be illustrated by a case where a taxpayer provides one of his customers with tickets to an amusement event. Here both the entertainment and gift provisions might apply. Under the regulations the entertainment provision always will apply with respect to such theater tickets regardless of whether the taxpayer accompanies the customer to the theater or sends him the tickets. On the other hand, gifts of a chattel such as a book or a toy will be classified as a gift, coming within the purview of subsection (b), even though the use of the item results in the entertainment of the recipient. Packaged food and beverages will be treated as gifts, while food and beverages consumed at meals will be considered entertainment.

The problem of properly characterizing an expenditure for purposes of determining whether section 274 is applicable, or whether the expenditure is to be treated solely under some other section, can be illustrated by a case where a taxpayer distributes to each of his customers a valuable gift which is inscribed with the taxpayer's name. Expenditures for such items might be characterized as advertising expenses or as expenses for gifts. Under the regulations, expenditures for such items will be characterized as gifts.

SECTION 4. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES (Continued)

(b) *Traveling expenses.*—The House bill amended section 162(a)(2) of the 1954 Code (relating to traveling expenses while away from home) by striking out the existing provision under which the "entire" amount expended for meals and lodging is included in the allowable deduction and would have substituted therefor a provision under which there is to be included a "reasonable" allowance expended for meals and lodging. In lieu of the House provision your committee's amendment provides that the allowable deduction is to include amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances.

(c) *Effective date.*—The House bill provided that the amendments made by section 4 are to apply with respect to taxable years ending after June 30, 1962, but only with respect to periods after such date. Your committee's action makes this provision effective with respect to taxable years ending after December 31, 1962, but only with respect to periods after such date.

SECTION 5. AMOUNT OF DISTRIBUTION WHERE CERTAIN FOREIGN CORPORATIONS DISTRIBUTE PROPERTY IN KIND

(a) *Amount distributed.*—Subsection (a) of section 5 of the bill amends section 301(b)(1) (relating to amount distributed to corporate distributees) of the 1954 Code by adding at the end thereof a new subparagraph (C). The general rule in new subparagraph (C) provides that for purposes of section 301 the amount of a distribution of property (other than money) received by a corporate shareholder from a foreign corporation will be the fair market value of such property.

An exception to the general rule is provided in cases where a dividends received deduction is allowable under section 245 with respect to such a distribution. In such a case, to the extent the distribution of such property is out of earnings and profits described in section 245(a) (1) and (2), the amount to be taken into account (for purposes of sec. 301 of the code) with respect to property other than money is the sum, determined under regulations prescribed by the Secretary of the Treasury or his delegate, of the amounts computed under subparagraphs (C)(i) and (C)(ii). The amount under subparagraph (C)(i) is that proportion of the lesser of—

(1) the fair market value of such property, or

(2) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of such property,

which is properly attributable to gross income from sources within the United States. The amount under subparagraph (C)(ii) is that proportion of the fair market value of such property which is properly attributable to gross income from sources without the United States.

The application of subparagraph (C) may be illustrated by the following example involving corporation X, a domestic corporation which owns 100 percent of the outstanding stock of corporation Y, a foreign corporation. Corporation Y, which makes its return on the basis of the calendar year, has earnings and profits of $200,000 for 1963 and derives 60 percent of its gross income from sources within the United States during 1963. For an uninterrupted period of 36 months ending with the close of 1963, corporation Y has been engaged in trade or business within the United States and has derived 50 percent or more of its gross income from sources within the United States. Assume that the only distribution made by corporation Y during 1963 is a distribution of property which has a fair market value of $100,000 and an adjusted basis (in the hands of the distributing corporation immediately before the distribution) of $40,000. The amount of the distribution of such property as determined under section 301(b)(1)(C) is $64,000, computed as follows:

(1) Amount computed under section 301(b)(1)(C)(i): That proportion of the adjusted basis of such property (since it is less than the fair market value) which is properly attributable to gross income from sources within the United States, that is, adjusted basis multiplied by the ratio which gross income from sources within the United States bears to gross income from all sources. $40,000×60 percent	$24,000
(2) Amount computed under section 301(b)(1)(C)(ii): That proportion of the fair market value of such property which is properly attributable to gross income from sources without the United States, that is, fair market value multiplied by the ratio which gross income from sources without the United States bears to gross income from all sources. $100,000×40 percent	40,000
(3) Amount of distribution of property for purposes of section 301	64,000

(b) *Basis.*—Subsection (b) of section 5 of the bill amends section 301(d) of the code (relating to basis of property) by adding a new paragraph (3). The new paragraph (3) provides that where the amount of a distribution of property other than money is determined in accordance with the provisions of subparagraph (C) of section 301(b)(1), the basis of such property shall be the amount of the property distribution. Thus, in the above example the property distributed would have a basis in the hands of corporation X, the distributee, of $64,000, the amount of the distribution.

(c) *Dividends received from certain foreign corporations.*—Paragraph (1) of subsection (c) of section 5 of the bill amends section 245 of the 1954 Code (relating to dividends received from certain foreign corporations) by adding a new subsection (b). The new subsection (b) provides that for purposes of computing the dividends received deduction under section 245(a) the amount of any distribution of property other than money shall be determined under section 301 (b)(1)(B). Under section 301(b)(1)(B) the amount of a distribution of property to a corporate shareholder is the lesser of (1) the fair market value of such property, or (2) the adjusted basis of such property (in the hands of the distributing corporation immediately before the distribution). Thus, for purposes of section 245, the amount of the dividend in the above example would be $40,000, rather than $64,000, and the amount allowed as a deduction under section 245 would be $20,400 ($40,000×60 percent×85 percent).

Paragraph (2) of subsection (c) of section 5 of the bill amends section 245 of the 1954 Code so as to designate the existing text as subsection (a) of section 245.

Subsection (d) of section 5 of the House bill, which provides that the section 301(b)(1)(B) amount of a distribution of property other than money is to be used in computing the credit for foreign taxes under section 902, has been deleted. Therefore, the section 301(b)(1)(C) amount will be used in this respect.

(d) *Effective date.*—Subsection (d) of section 5 of the bill, identical with subsection (e) of such section of the bill as passed by the House, provides that the amendments made by section 5 of the bill shall apply to distributions made after December 31, 1962.

SECTION 6. MUTUAL SAVINGS BANKS, ETC.

(a) *In general.*—Subsection (a) of section 6 of the bill as reported, which corresponds to section 8 of the bill as passed by the House, amends section 593 of the 1954 Code to provide a new method for

calculating the deduction for additions to bad debt reserves allowable to the mutual savings banks, domestic building and loan associations, and cooperative banks, referred to in section 593(a) (all of which are hereinafter referred to as mutual savings institutions).

SECTION 593. RESERVES FOR LOSSES ON LOANS

(a) *Organizations to which section applies.*—Subsection (a) of section 593, as amended by the bill, provides that section 593 is to apply to any mutual savings bank not having capital stock represented by shares, domestic building and loan association, or cooperative bank without capital stock organized and operated for mutual purposes and without profit. This description of the organizations to which the amended section 593 applies is substantially the same as that contained in section 593 of existing law, and no substantive change is made by this change in description. As is noted below, however, section 7701(a)(19) (definition of domestic building and loan association) was amended by section 8(c) of the bill as passed by the House, and section 6(c) of the bill as reported by your committee further amends such section.

(b) *Additions to reserves for bad debts.*—Subsection (b)(1) prescribes the method for determining the reasonable addition for the taxable year to the reserve for bad debts under section 166(c), and also specifies the reserves to which such additions shall be made. Such reasonable addition is the sum of two amounts—(1) the amount added to the reserve for losses on nonqualifying loans, and (2) the amount added to the reserve for losses on qualifying real property loans.

The first amount is that determined under section 166(c) to be a reasonable addition to the reserve for losses on nonqualifying loans. Nonqualifying loans are defined in subsection (e)(2), and (with certain exceptions) are loans other than loans secured by an interest in improved real property.

The second amount is the amount determined by the taxpayer to be a reasonable addition to the reserve for losses on qualifying real property loans. Qualifying real property loans are defined in subsection (e)(1) and (with certain exceptions) are loans secured by an interest in improved real property. Under the bill as passed by the House, the amount of the reasonable addition to the reserve for losses on such loans could not exceed the amount determined under one of three different methods described in paragraphs (2), (3), and (4) of subsection (b), whichever method produced the largest amount.

Your committee has amended subsection (b)(1) to provide that the amount of the addition for a taxable year to the reserve for losses on qualifying real property loans, when added to the amount of the addition to the reserve for losses on nonqualifying loans, shall in no case be greater than the amount by which 12 percent of the total deposits or withdrawable accounts of depositors of the taxpayer at the close of such year exceeds the sum of its surplus, undivided profits, and reserves at the beginning of such year (taking into account any portion thereof attributable to the period before the first taxable year beginning after December 31, 1951).

Percentage of taxable income method

This method is described in subsection (b)(2). Under the bill as passed by the House the amount of the reasonable addition to the reserve for losses on qualifying real property loans for a taxable year was limited to the excess of an amount equal to 60 percent of the taxable income for such year over the amount determined under section 166(c) to be a reasonable addition to the reserve for losses on nonqualifying loans. For purposes of this method, taxable income is determined without regard to any deduction under section 166(c) for any additions to the reserves for bad debts, and also by excluding from gross income any amount included therein by reason of subsection (f) (relating to the treatment of certain distributions of property to stockholders by a domestic building and loan association).

Your committee has made two amendments to subsection (b)(2). The first amends subparagraph (A) of subsection (b)(2) to provide that the amount computed under that subparagraph shall be an amount equal to 50 percent of taxable income for the taxable year (rather than 60 percent) in the case of a taxpayer which is a domestic building and loan association having capital stock with respect to which any distribution of property (as defined in sec. 317(a)) is not allowable as a deduction under section 591. In the case of a mutual savings institution other than one described in the preceding sentence the percentage figure remains at 60 percent.

Your committee's second amendment to subsection (b)(2) provides that the amount of the addition determined thereunder shall not exceed such amount as is necessary to increase the balance (as of the close of the taxable year) of the reserve for losses on qualifying real property loans to 6 percent of such loans outstanding at such time.

Percentage of real property loans method

Under this method, which is described in subsection (b)(3) and which has been amended by your committee to provide a special deduction for certain new companies, the amount of the reasonable addition to the reserve for losses on qualifying real property loans is limited to the amount necessary to increase the balance (as of the close of the taxable year) of such reserve to an amount equal to the amount described in subparagraph (A) or equal to the sum of two amounts which are described in subparagraphs (A) and (B) of such subsection. The first amount, which applies in the case of all mutual savings institutions, is an amount equal to 3 percent of qualifying real property loans outstanding at the close of the taxable year. The second amount applies only to a mutual savings institution which is a "new company" and which does not have capital stock with respect to which distributions of property (as defined in sec. 317(a)) are not allowable as a deduction under section 591. In the case of such an institution, such second amount is equal to (i) 2 percent of such loans outstanding, or 2 percent of $4 million, whichever is the lesser, reduced (but not below zero) by (ii) the amount, if any, of the balance (as of the close of the year) of the taxpayer's supplemental reserve for losses on loans. For purposes of computing such second amount, a mutual savings institution qualifies as a "new company" for any taxable year only if such taxable year begins not more than 10 years after the first day on which it (or any predecessor) was authorized to do business as an organization described in section 593(a).

Experience method

Under this method, described in subsection (b)(4), the amount of the reasonable addition to the reserve for qualifying real property loans is limited to the amount determined under section 166(c) (without regard to sec. 593(b)) to be a reasonable addition to such reserve.

(c) *Treatment of reserves for bad debts.*—Subsection (c)(1) of section 593 as amended provides that each mutual savings institution which uses the reserve method of accounting for bad debts is to establish and maintain a reserve for losses on qualifying real property loans, a reserve for losses on nonqualifying loans, and a supplemental reserve for losses on loans. Except as provided in the last sentence of paragraph (5) of this subsection, which is a new paragraph added by your committee, such reserves are to be treated for all purposes as reserves for bad debts. Thus, although these reserves are termed reserves for "losses," they are reserves for bad debts; and any charge to any such reserve for an item other than a bad debt will result in the inclusion in gross income of an amount equal to such charge. As is indicated below, however, any portion of the reserve for losses on qualifying real property loans which represents amounts allocated thereto pursuant to subsection (c)(5) shall not be treated as a reserve for bad debts for any purpose other than the determination of the amount deductible under subsection (b).

Allocation of pre-1963 reserves

Paragraphs (2) and (3) of subsection (c) prescribe rules governing the method of allocating pre-1963 reserves among the three reserves described above. The term "pre-1963 reserves" is defined by paragraph (4) to mean the net amount, determined as of the close of December 31, 1962 (after applying the provisions of subsec. (d)(1) relating to taxable years beginning in 1962 and ending in 1963), accumulated in the reserve for bad debts pursuant to section 166(c) (or the corresponding provisions of prior revenue laws), whether or not determined with reference to section 593, for taxable years beginning after December 31, 1951.

Paragraph (2) of subsection (c) provides that such pre-1963 reserves shall, as of the close of December 31, 1962, be allocated to, and constitute the opening balances of, the reserve for losses on nonqualifying loans, the reserve for losses on qualifying real property loans, and the supplemental reserve for losses on loans.

Paragraph (3) of subsection (c) provides that the pre-1963 reserves shall be allocated first to the reserve for losses on nonqualifying loans to the extent that such reserve is not increased above the amount which would constitute a reasonable addition under section 166(c) for a period in which such nonqualifying loans increased from zero to the amount thereof outstanding at the close of December 31, 1962. Thus, the pre-1963 reserves will be allocated to the reserve for losses on nonqualifying loans in an amount not in excess of the maximum amount (determined without regard to any annual limitation which might be imposed under sec. 166(c) on building such reserve to its full amount) which could have been added, as of the close of 1962, to such reserve under subsection (b)(1)(A) if the balance of such reserve immediately prior to such addition had been zero. The remaining portion of the pre-1963 reserves is then allocated to the reserve for

losses on qualifying real property loans to the extent such reserve is not increased above the larger of two amounts. The first amount is the amount which would be determined under paragraph (3)(A) of subsection (b) as being necessary to increase the balance of the reserve from zero to 3 percent of qualifying real property loans outstanding at the close of December 31, 1962. The second amount is the amount which would be determined under section 166(c) (without regard to sec. 593) to be a reasonable addition to the reserve for losses on qualifying real property loans for a period in which such loans increased from zero to the amount thereof outstanding at the close of December 31, 1962. Any remaining balance of the pre-1963 reserves is allocated to the supplemental reserve for losses on loans.

Paragraph (5) of subsection (c) is a new provision which your committee has added to the bill. This paragraph provides that if, after the allocation of pre-1963 reserves to the reserves for losses on nonqualifying loans and for losses on qualifying real property loans, the opening balance of the reserve for losses on qualifying real property loans is less than the maximum amount prescribed by paragraph (3)(B), then, for purposes of subsection (c), the term "pre-1963 reserves" shall also include so much of the taxpayer's "pre-1952 surplus" as does not exceed the amount by which such opening balance is less than the amount described in such paragraph (3)(B). As used in the preceding sentence the term "pre-1952 surplus" refers to the taxpayer's surplus, undivided profits, and bad debt reserves determined as of December 31, 1962, and attributable to the period before the first taxable year beginning after December 31, 1951, but does not include any portion thereof attributable to interest which would have been excludable from gross income under section 22(b)(4) of the Internal Revenue Code of 1939 (relating to interest on governmental obligations) or the corresponding provisions of prior revenue laws.

Paragraph (5) also provides that, notwithstanding the second sentence of paragraph (1) (which requires that the three reserves established pursuant to subsec. (c) shall be treated as reserves for bad debts), any portion of the pre-1952 surplus included in the reserve for losses on qualifying real property loans shall not be treated as a reserve for bad debts for any purpose other than determining the amount of the addition to the reserve for losses on qualifying real property loans, and for such purpose such portion shall be treated as remaining in such reserve. Thus, such portion of the pre-1952 surplus as is included in the reserve for losses on qualifying real property loans as of the close of December 31, 1962, shall be deemed to be included in the balance of such reserve as of the close of each taxable year to which the amended section 593 applies, but only for the limited purpose of determining the maximum permissible addition to such reserve under subsection (b). For all other purposes such portion of the pre-1952 surplus will retain the character that it has under existing law. The effect of your committee's addition of paragraph (5) to subsection (c) is to place an institution which accumulated most of its reserves and surplus prior to 1952 on the same basis, for purposes of computing future additions to reserves, as an institution which accumulated most of its reserves after 1951.

Subsection (c)(6), which is identical to subsection (c)(5) of section 593 in the bill as passed by the House, provides that any debt becoming worthless or partially worthless in respect of a qualifying real

property loan shall be charged to the reserve for losses on such loans, and any debt becoming worthless or partially worthless in respect of a nonqualifying loan shall be charged to the reserve for losses on nonqualifying loans; except that any such debt may, at the election of the taxpayer, be charged in whole or in part to the supplemental reserve for losses on loans.

(d) *Taxable years beginning in 1962 and ending in 1963.*—Subsection (d) of the amended section 593 contains provisions for the computation of taxable income in the case of a taxable year which is a fiscal year beginning in 1962 and ending in 1963. With certain exceptions, the general effective date provision in section 6(g)(1) of the bill makes the amended section 593 applicable with respect to taxable years ending after December 31, 1962. However, subsection (d) makes section 593 take effect with respect to fiscal year taxpayers as of January 1, 1963. Subsection (d) apportions taxable income for the entire taxable year (determined without regard to any deduction under sec. 166(c)) between the part of the taxable year which falls in 1962 and the part which falls in 1963. Such taxable income is allocated to each part year on the basis of the ratio which the number of days in each such part year bears to the number of days in the entire taxable year. The portion of such taxable income allocable to the part of the year occurring before January 1, 1963, is then reduced under subsection (d)(1) by an amount equal to the deduction which would have been allowable under section 166(c) for an addition to the reserve for bad debts as if such part year constituted a taxable year and as if section 593, as in effect before the amendments made by section 6 of the bill, applied. The portion of such taxable income allocable to the part of the taxable year occurring after December 31, 1962, is reduced, under subsection (d)(2), by an amount equal to the deduction for an addition to a reserve for bad debts which would be allowed under section 166(c) (taking into account the amendments made by sec. 6 of the bill) if such part year constituted a taxable year. The amounts of taxable income thus obtained for each part year are then added to obtain the taxable income for the entire taxable year.

The amount of the deduction allowable for the pre-1963 part year to a mutual savings institution under subsection (d)(1) is limited, by reason of section 593(2) of existing law, to the amount by which 12 percent of the total deposits or withdrawable accounts of its depositors at the close of such part year (Dec. 31, 1962) exceeds the sum of its surplus, undivided profits, and reserves at the beginning of the taxable year. In addition, by reason of section 593(1) of existing law, the deduction allowable under subsection (d)(1) for the pre-1963 part year to a mutual savings institution cannot exceed the amount of its taxable income (determined without regard to any deduction under sec. 166) allocable to the pre-1963 part year. Although the amount of the deduction allowable for the pre-1963 part year under subsection (d)(1) cannot be determined until the close of the entire taxable year (by reason of the taxable income limitation and because the amount must be reflected on the institution's regular books of account), this amount is added to the institution's pre-1963 reserves. The pre-1963 reserves are then allocated under the rules of subsection (c), as of the close of December 31, 1962, by reference to the amount of nonqualifying loans and qualifying real property loans outstanding at that time.

The deduction referred to in subsection (d)(2) for the post-1962 part year is determined under subsection (b) and is equal to the sum of the amount of an addition to the reserve for losses on nonqualifying loans plus the amount of an addition to the reserve for qualifying real property loans. The amount of the addition to the reserve for nonqualifying loans is computed by reference to the amount of such loans outstanding at the close of the taxable year in relation to the balance in the reserve for such loans at that time. The amount of the addition to the reserve for qualifying real property loans, if determined under the percentage of taxable income method, would be equal to the excess of an amount equal to 60 percent (or 50 percent, as the case may be) of the taxable income (determined under subsec. (b)(2)) which is allocable to the post-1962 part year over the amount of the reasonable addition to the reserve for nonqualifying loans. If the addition to the reserve for qualifying real property loans is determined under the percentage of real property loans method or the experience method, it would be computed by reference to the amount of such loans outstanding at the close of the taxable year in relation to the balance in the reserve for such loans at that time.

(e) *Loans defined.*—Subsection (e) of the amended section 593 defines, for purposes of that section, the terms "qualifying real property loans", "nonqualifying loans", and "loans".

The term "loan" is defined to mean debt, as the term "debt" is used in section 166. Since subsection (e) of section 166 is made inapplicable by section 582(a) in the case of a mutual savings institution, the term "loan" includes a debt evidenced by a security as defined in section 165(g)(2)(C). For purposes of subsection (e), a taxpayer will be considered to have made a loan to the extent of his participation in the loan, whether the loan was made by him or by another person.

Under paragraph (1) of subsection (e), a "qualifying real property loan" is defined to mean any loan of the taxpayer which is secured by an interest in improved real property unless such loan is described in subparagraph (A), (B), (C), or (D) of such paragraph. The loans described in these subparagraphs are: (A) any loan evidenced by a security (as defined in sec. 165(g)(2)(C)); (B) any loan, whether or not evidenced by a security as defined in section 165(g)(2)(C), the primary obligor on which is a government or political subdivision or instrumentality thereof, a bank as defined in section 581, or another member of the same affiliated group; (C) any loan to the extent secured by a deposit in or share of the taxpayer; and (D) any loan which, within a 60-day period beginning in one taxable year of the creditor and ending in its next taxable year, is made or acquired and then repaid or disposed of, unless the transactions by which such loan was made or acquired and then repaid or disposed of, are established by the taxpayer to be for bona fide business purposes.

The term "affiliated group" is defined as having the meaning assigned to such term by section 1504(a) of existing law; except that (1) the phrase "more than 50%" shall be substituted for the phrase "at least 80%" each place it appears in section 1504(a), and (2) all corporations shall be treated as includible corporations (without any exclusion under sec. 1504(b)).

Paragraph (2) of subsection (e) defines the term "nonqualifying loan" as any loan of the taxpayer which is not a qualifying real property loan as defined by the bill. Thus, a loan which is, for example,

evidenced by a security as defined in section 165(g)(2)(C), is treated as a nonqualifying loan irrespective of the fact that it may be secured by improved real property.

(f) *Distributions to shareholders.*—Subsection (f) of the amended section 593 prescribes rules governing certain distributions of property (as defined in sec. 317(a)) by a domestic building and loan association to a shareholder with respect to its stock, if such distribution is not allowable as a deduction under section 591. The term "distribution" is defined to include any distribution in redemption of stock or in partial or complete liquidation of the association, as well as dividend distributions as defined in section 316(a).

Paragraph (1) of subsection (f) provides, in general, that a distribution with respect to its capital stock is to be treated as made, first, out of the association's earnings and profits accumulated in taxable years beginning after December 31, 1951 (to the extent thereof); second, out of the reserve for losses on qualifying real property loans, to the extent the additions to such reserve exceed the additions which would have been allowed under the experience method described in subsection (b)(4); third, out of the supplemental reserve for losses on loans (to the extent thereof); and, finally, out of such other accounts as may be proper. The foregoing order of charging applies to all subsection (f) distributions other than those in redemption of stock or in partial or complete liquidation of the association. In these latter situations the distribution is treated as made, first, out of the reserve for losses on qualifying real property loans to the extent the additions to such reserve exceed the additions which would have been allowed under the experience method described in subsection (b)(4); second, out of the supplemental reserve (to the extent thereof); third, out of earnings and profits accumulated in taxable years beginning after December 31, 1951 (to the extent thereof); and, finally, out of other appropriate accounts. In determining the portion of the reserve for losses on qualifying real property loans out of which a distribution described in subsection (f)(1) is treated as made, the word "additions," as used in subparagraph (B) of subsection (f)(1), includes both the additions made to such reserve under subsection (b)(1)(B) and the amount of the pre-1963 reserves allocated thereto pursuant to subsection (c)(3). In computing the amount of the additions which would have been allowed under the experience method, the amount of the pre-1963 reserves initially allocated, and the subsequent additions, to the reserve for losses on qualifying real property loans shall be computed solely by reference to the experience method.

Paragraph (2) of subsection (f) provides that, if a distribution described in paragraph (1) is treated as having been made out of the reserve for losses on qualifying real property loans or out of the supplemental reserve for losses on loans, the amount charged against such reserve shall be the amount which, when reduced by the amount of Federal income tax attributable to the inclusion of such amount in gross income, is equal to the amount of such distribution. Any amount so charged against such reserve shall be included in the gross income of the distributor association. Since the amount so included in gross income is also included in earnings and profits, the effect of subsection (f) is to treat such amount as having been first transferred from the reserves to earnings and profits and then charged to earnings and profits. Thus, this rule will normally insure that there will be

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earnings and profits sufficient to make distributions which are in reality dividends taxable as such, even though the association has previously deducted, in computing its earnings and profits, the amount of additions to its bad debt reserves. However, apart from the consequences which flow from the fact that earnings and profits will be created by such charges to the reserves, income tax consequences to stockholders are not otherwise affected by subsection (f).

Paragraph (3) of subsection (f) provides special rules. Subparagraph (A) provides that, for purposes of treating a distribution as having been made out of the reserve for losses on qualifying real property loans, additions to such reserve for the taxable year in which the distribution occurs shall be taken into account. Thus, the amount of such reserve will be augmented by the addition to such reserve computed under subsection (b) before the reserve is reduced by reason of treating a distribution as having been made out of the reserve. Subparagraph (B) provides that, for purposes of computing (under sec. 593, as amended by the bill) the amount of a reasonable addition to the reserve for losses on qualifying real property loans for any taxable year, any amount charged during any year to such reserve pursuant to the provisions of paragraph (2) of subsection (f) shall not be taken into account. Thus, the amount by which such reserve is reduced by reason of distributions to stockholders cannot serve as the basis for subsequent deductible additions to such reserve.

SECTION 6. MUTUAL SAVINGS BANKS, ETC. (Continued)

(b) *Foreclosure on property securing loans.*—Subsection (b) of section 6 adds a new section 595 to the code. The section applies only to a creditor which is a mutual savings institution described in the amended section 593(a).

Nonrecognition of gain or loss as a result of foreclosure

Subsection (a) of the new section 595 provides that in the case of a creditor which is an organization described in section 593(a), no gain or loss shall be recognized, and no debt shall be considered as becoming worthless or partially worthless, as the result of such organization having bid in at foreclosure, or having otherwise reduced to ownership or possession by agreement or process of law, any property which was security for the payment of any indebtedness.

Character of property

Subsection (b) of the new section 595 provides that, for purposes of sections 166 (relating to the deduction for bad debts) and 1221 (relating to the definition of a capital asset), any property acquired in a transaction with respect to which gain or loss was not recognized to the creditor by reason of subsection (a) shall be considered as property having the same characteristics as the indebtedness for which such property was security. The subsection further provides that any amount realized by such creditor with respect to such property shall be treated (for purposes of ch. 1 of the code) as a payment on account of such indebtedness, and that any loss with respect to such property shall be treated as a bad debt to which the provisions of section 166 apply.

Basis

Subsection (c) of the new section 595 provides that the basis of any property acquired in a transaction to which subsection (a) applies shall be the basis of the indebtedness for which such property was security, determined as of the date of the acquisition of such property, properly increased for any costs of acquisition.

Regulatory authority

Subsection (d) of the new section 595 provides that the Secretary of the Treasury or his delegate shall prescribe such regulations as he may deem necessary to carry out the purposes of this section.

(c) *Definition of a domestic building and loan association.*—Subsection (c) of section 6 amends section 7701(a)(19) of the code to provide a new definition of the term "domestic building and loan association." As amended by your committee, paragraph (19) of section 7701(a) defines this term to mean any domestic building and loan association, domestic savings and loan association, or Federal savings and loan association, which meets each of the requirements prescribed by subparagraphs (A) through (E) of such paragraph. For purposes of convenience, such associations are hereinafter referred to as "domestic savings associations."

Subparagraph (A) of paragraph (19) provides that the domestic savings association must be either an insured institution within the meaning of section 401(a) of the National Housing Act (12 U.S.C., sec. 1724(a)), or subject by law to supervision or examination by State or Federal authority having supervision over such associations. The "insured institutions" referred to are those the accounts of which are insured by the Federal Savings and Loan Insurance Corporation.

Subparagraph (B) thereof requires that substantially all the business of the domestic savings association consist of acquiring the savings of the public and investing in loans described in subparagraph (C). Thus, even though such an association otherwise meets the asset requirements imposed by subparagraphs (C), (D), (E), and (F) of paragraph (19), it will nevertheless not qualify as a domestic building and loan association if more than an insubstantial portion of its business consists of, for example, mortgage or insurance brokerage activities.

Subparagraph (C) of paragraph (19) requires that at least 90 percent of the amount of the total assets of a domestic savings association must consist of (i) cash (including time or demand deposits with, or withdrawable accounts in, other financial institutions), (ii) obligations of the United States or of a State or political subdivision thereof, and stock or obligations of a corporation which is an instrumentality of the United States, or of a State or political subdivision thereof, (iii) loans secured by an interest in real property and loans made for the improvement of real property, (iv) loans secured by a deposit or share of a member of such association, and (v) property acquired through the liquidation of defaulted loans which are secured by an interest in real property or which are made for the improvement of such property. In determining whether the percentage requirements imposed by paragraph (19) are met, the amount of each item included in the amount of total assets of a domestic savings association shall be measured by the adjusted basis of such item, as determined under section 1011 (relating to the adjusted basis

for determining gain or loss), or by such other method as is in accordance with sound accounting principles.

Subparagraph (D) of paragraph (19) provides that, of the assets which are taken into account by the taxpayer under subparagraph (C) as assets constituting the 90 percent of total assets, at least 80 percent of such 90 percent must consist of (1) cash and governmental obligations described in clauses (i) and (ii) of subparagraph (C), and (2) loans secured by an interest in real property which is (or, from the proceeds of the loan, will become) residential real property, or of loans which are made for the improvement of such residential real property. Subparagraph (D) further provides that at least 70 percent of such 90 percent must consist of (1) cash and governmental obligations described in clauses (i) and (ii) of subparagraph (C), and (2) loans secured by an interest in real property which is (or, from the proceeds of the loan, will become) residential real property containing four or fewer family units, or of loans made for the improvement of residential real property containing four of fewer family units.

Subparagraph (E) of paragraph (19) provides that not more than 18 percent of the total assets of the taxpayer may consist of assets other than those described in clause (i) of subparagraph (D) (cash, certain Government obligations, and loans secured by an interest in improved residential real property); and not more than 27 percent of the total assets of the taxpayer may consist of assets other than those described in clause (ii) of subparagraph (D) (cash, certain Government obligations, and loans secured by one- to four-family residential real property). However, the 18- and 27-percent limitations contained in this subparagraph shall be increased by the number, if any, of percentage points (including any fraction of a percentage point) by which 10 percent exceeds the percentage of the total assets consisting of assets described in clauses (i) and (ii) of subparagraph (C) (cash and certain governmental obligations). Thus, a mutual savings institution may not have more than 18 percent of its total assets in commercial loans, nor more than 27 percent of its total assets in commercial loans and loans secured by apartment buildings, except to the extent its cash and governmental obligations constitute less than 10 percent of its assets.

Subparagraph (F) of paragraph (19) provides that none of the assets of a domestic savings association may be invested in the stock of any corporation, other than stock of a corporation which is an instrumentality of the United States or of a State or political subdivision thereof, stock acquired through the liquidation of a defaulted loan which was secured by an interest in real property or made for the improvement of real property, or stock representing a withdrawable account in another financial institution.

(d) *Clerical amendments.*—Subsection (d) of section 6 contains clerical amendments.

(e) *Repeal of exemption from certain excise taxes.*—Under section 5(h) of the Home Owner's Loan Act of 1933 (48 Stat. 132; 12 U.S.C., sec. 1464(h)), Federal savings and loan associations are exempted from Federal taxes other than payroll taxes and income, war profits, and excess profits taxes, the legal incidence of which would fall upon such associations. Thus, under existing law Federal savings and loan associations are not subject to the excise taxes which sections 4251 and 4261 of the code impose, respectively, on communications and the transportation of persons. Subsection (d) of this section of the

bill as passed by the House eliminated the exemption which section 5(h) of the Home Owner's Loan Act accorded those associations with respect to the taxes imposed by sections 4251 and 4261. Paragraph (1) of subsection (e) of this section of the bill, as reported by your committee, amends section 5(h) of the Home Owner's Loan Act so as to eliminate entirely the exemption from Federal taxes which that section now provides in the case of Federal savings and loan associations.

Under section 4382(a)(2) of the code, capital stock and certificates of indebtedness issued by domestic building and loan associations (as defined in sec. 7701(a)(19)) and cooperative banks are exempt from the documentary stamp taxes imposed by chapter 34 of the code. Your committee has added a new paragraph (2) to section 6(e) of the bill which eliminates this exemption insofar as it extends (i) to all certificates of indebtedness (as defined in sec. 4381(a)) issued by a domestic building and loan association or cooperative bank, and (ii) to shares or certificates of stock issued by such a domestic building and loan association or cooperative bank with respect to which any distribution of property (as defined in sec. 317(a)) is not allowable as a deduction under section 591. Thus, your committee's amendment of section 4382(a)(2) continues the exemption which that section provides in the case of shares or certificates of stock issued by such associations or banks and representing deposits or withdrawable accounts, as well as the exemption which it provides in the case of all shares or certificates of stock and certificates of indebtedness issued by mutual ditch or irrigation companies. As used in section 6(e)(2) of the bill, the term "domestic building and loan association" includes homestead associations which qualify under the amended definition of domestic building and loan associations contained in section 6(c) of the bill.

(f) *Deduction for dividends or interest paid on deposits.*—Subsection (f) of section 6 of the bill, which has been added by your committee, amends section 591 of existing law by providing that—in addition to mutual savings banks, cooperative banks, and domestic building and loan associations—savings institutions chartered and supervised as savings and loan associations or similar associations under Federal or State law shall be allowed as a deduction in computing taxable income amounts paid to, or credited to the accounts of, depositors or holders of accounts as dividends or interest on their deposits or withdrawable accounts, if such amounts paid or credited are withdrawable on demand subject only to customary notice of intention to withdraw. Thus, even though an association chartered and supervised as a savings and loan or similar association under Federal or State law may not qualify as a domestic building and loan association as defined in section 7701 (a)(19), as amended, your committee's amendment will insure the deductibility of dividends or interest paid on such withdrawable accounts or deposits.

(g) *Effective dates.*—Subsection (g) of section 6 of the bill provides effective dates for subsections (a), (b), (c), and (e) of section 6 of the bill.

Paragraph (1) of section 6(g) of the bill provides that the amendments made by section 6(a) of the bill (which amends sec. 593 of existing law) shall apply to taxable years ending after December 31, 1962, except that section 593(f) of the code shall apply to distributions made after December 31, 1962, in taxable years ending after such date.

Paragraph (2) of section 6(g) of the bill provides that the amendments made by section 6(b) of the bill (which adds a new sec. 595) shall apply to transactions described in section 595(a) of the code occurring after December 31, 1962, in taxable years ending after such date.

Paragraph (3) of section 6(g) of the bill provides that the amendment made by section 6(c) of the bill (which amends section 7701(a)(19) of existing law) shall apply to taxable years beginning after the date of the enactment of the bill.

Paragraph (4) of section 6(g) of the bill, as amended by your committee, provides that subsection (e) of the bill shall become effective on January 1, 1963, except that, in the case of the tax imposed by section 4251 of the code, subsection (e) shall apply only with respect to amounts paid pursuant to bills rendered after December 31, 1962; and, in the case of the tax imposed by section 4261 of the code, subsection (e) shall apply only with respect to transportation beginning after December 31, 1962.

SECTION 7. DISTRIBUTIONS BY FOREIGN TRUSTS

This section is the same as section 9 of the bill as passed by the House, with two exceptions. First, your committee has changed the definition of the term "foreign trust created by a U.S. person" so that a foreign trust will come within the definition only to the extent of money or property (including accumulated earnings therefrom) transferred to the trust by a U.S. person or under the will of a U.S. citizen or resident. Second, a change has also been made in the effective date provision to provide that the amendments made by the bill shall apply to distributions made after the date of enactment of the bill.

(a) *Definitions.*—Section 7(a) of the bill amends section 643 of the 1954 Code (definitions relating to the income of estates and trusts) in the following respects:

Modification of distributable net income.—Section 7(a)(1) of the bill amends section 643(a) (relating to modifications taken into account in computing distributable net income) in two respects. First, a new subparagraph (B) is added to section 643(a)(6) to provide that the gross income of a foreign trust from sources within the United States is to be determined without regard to section 894 (relating to income exempt under treaty). A further amendment is made to section 643(a)(6) by the addition of a new subparagraph (C). The new section 643(a)(6)(C) provides that section 643(a)(3) (relating to capital gains and losses) is not to apply to a "foreign trust created by a U.S. person," as defined in section 643(d). In lieu of the rules provided by section 643(a)(3), the new subparagraph (C) provides that there is to be included in distributable net income gains from the sale or exchange of capital assets, reduced by losses from such sales or exchanges to the extent such losses do not exceed gains from such sales or exchanges. The new subparagraph (C) also provides that the deduction under section 1202 (relating to deduction for excess of capital gains over capital losses) is not to be taken into account. Existing section 643(a)(3) will continue to apply to trusts other than foreign trusts created by U.S. persons.

Foreign trusts created by U.S. persons

Section 7(a)(2) of the bill adds a new subsection (d) to section 643 of the 1954 Code. The new section 643(d) provides that, for purposes of part I of subchapter J (relating to estates, trusts, and beneficiaries), the term "foreign trust created by a U.S. person" means the portion of a foreign trust (as defined in sec. 7701(a)(31)) attributable to money or property transferred to it directly or indirectly by a U.S. person (as defined in sec. 7701(a)(30)), or under the will of a decedent who at the date of his death was a U.S. citizen or resident, and including all accumulated earnings, profits, or gains attributable to such money or property. A foreign trust, created by a person who is not a U.S. person, to which a U.S. person transfers money or property would under this definition be in part a foreign trust created by a U.S. person.

(b), (c), and (d) *Modification of throwback.*—Subsections (b) through (d) of section 7 of the bill make various amendments designed to modify the so-called throwback provisions of the code in their application to certain foreign trusts.

Existing law

Under existing law the so-called throwback provisions of subchapter J operate substantially as follows: When a beneficiary receives as a distribution an amount in excess of current distributable net income, and the distribution exceeds $2,000, it is called an accumulation distribution. The beneficiary is taxed on this amount to the extent there was undistributed net income of the trust in any of the preceding 5 years, the undistributed net income of such prior years being taken into account in inverse order. Undistributed net income consists of undistributed distributable net income for a taxable year, minus the taxes on the trust attributable to such undistributed amount. The beneficiary is also required to include in gross income an appropriate portion of the U.S. income taxes, if any, imposed on the trust with respect to the undistributed net income, but he receives a tax credit based on the taxes the trust would not have had to pay if the undistributed distributable net income had actually been paid to the beneficiary.

Although under section 668(a) the beneficiary is taxable currently on the entire distribution, as well as on the taxes on the trust allocable to that amount, the tax attributable to the distribution cannot exceed the tax he would have paid had the distribution been paid to him on the last day of each of the preceding taxable years to the extent the undistributed net income of each of those years is considered absorbed by the distribution. The taxes deemed distributed to him are similarly spread back.

Under existing law, however, as noted, the throwback rule does not operate with respect to distributions made out of accumulations for taxable years before the fifth year preceding the taxable year. In addition, there are certain exceptions to what may be taken into account in determining whether there has been an accumulation distribution, e.g., a distribution out of accumulations for a minor, or a final distribution of the trust made to a beneficiary more than 9 years after the date of the last transfer to the trust.

Modification of accumulation distribution

Section 7(b)(1) of the bill amends section 665(b) (relating to the definition of accumulation distribution) to limit the application of

such definition to trusts other than foreign trusts created by U.S. persons. A new section 665(c), added by section 7(b)(2) of the bill, provides a definition of accumulation distribution for foreign trusts created by U.S. persons. Under this new definition, a distribution in excess of current distributable net income constitutes an accumulation distribution whether or not the distribution exceeds $2,000. In addition, there are no exceptions to what is taken into account in determining whether there has been an accumulation distribution. Thus, any distribution in excess of current distributable net income will, under the new section 665(c), be an accumulation distribution.

The last sentence of section 665(c) provides that any amount paid to a U.S. person which is from a payor who is not a U.S. person, and which is derived directly or indirectly from a foreign trust created by a U.S. person, is to be deemed in the year of payment to have been directly paid by the foreign trust. Thus, if a nonresident alien receives a distribution from a foreign trust created by a U.S. person and he then pays the amount of the distribution over to a U.S. person, the payment of such amount to the U.S. person represents an accumulation distribution to the U.S. person from such trust, to the extent that the amount received would have been an accumulation distribution had the trust paid the amount directly to the U.S. person. An example of a payment indirectly derived by a nonresident alien from such a foreign trust would be where the trust distributes to a foreign trust which was not created by a U.S. person, and which latter foreign trust makes a distribution to the nonresident alien. In this case, the payment over to a U.S. person is considered to have been made from the initial and not from the intervening trust. The same result would obtain if the intervening trust were a foreign trust created by a U.S. person. However, even if a payment is made to a U.S. person by a person who is not a U.S. person and who directly or indirectly derived the amount paid from a foreign trust created by a U.S. person, the receipt of the amount by the U.S. person is not considered the receipt of an accumulation distribution from a trust if the amount is received under circumstances indicating lack of intent on the part of the parties to circumvent the purposes of section 7 of the bill.

Other modifications of the throwback rule

The restriction of the throwback rule to the 5 preceding taxable years of the trust is removed by section 7(c)(2) of the bill for foreign trusts created by a U.S. person. However, this unlimited throwback will operate only for years governed by the 1954 Code.

Section 7(d) of the bill adds a new sentence to section 668(a) (relating to amounts treated as received in prior taxable years). In the case of a U.S. person who is a beneficiary of a foreign trust created by a U.S. person, this sentence conditions the availability of the limitation on tax provided by section 668(a) on a beneficiary's meeting the information requirements of new section 669(b), added by section 7(e) of the bill.

The provisions of subchapter J which remain unchanged by the bill will continue to apply as under existing law. Thus, the credit allowed to a beneficiary by section 668(b) for U.S. income taxes paid by the trust, and the credit against tax for taxes imposed by foreign countries will continue to be available.

(e) *Limitation on tax.*—Section 7(e) of the bill adds a new section 669 to subpart D of part 1 of subchapter J of chapter 1 (relating to treatment of excess distributions by trusts).

SECTION 669. SPECIAL RULES APPLICABLE TO CERTAIN FOREIGN TRUSTS

Section 669 provides that a beneficiary who is a U.S. person and who satisfies certain additional requirements may elect between two methods of computing the limitation on tax attributable to an accumulation distribution received from a foreign trust created by a U.S. person. These two methods are in addition to the method available to the beneficiary of computing his tax in the ordinary way by including in income the entire amount of an accumulation distribution when it is paid, credited, or required to be distributed. The additional requirements referred to which must be satisfied by the beneficiary are those provided in section 669(b), relating to the furnishing of certain information by the beneficiary with respect to the operation and accounts of the trust. Information may be required to be furnished for each taxable year of the trust on the last day of which an amount is deemed distributed by the trust under section 666(a). The nature and extent of the information required is to be determined by regulations prescribed by the Secretary of the Treasury or his delegate.

First method of limiting tax

As noted above, section 669(a) provides for an election by the beneficiary as between two methods of computing the limitation on tax attributable to the receipt of an accumulation distribution. The first method is the one provided by existing law, and which is now contained in the next to the last sentence of section 668(a). However, section 669(a)(2)(B) provides that this method may not be elected if the beneficiary was not alive on the last day of each preceding taxable year of the trust with respect to which a distribution is deemed made under section 666(a). Thus, if a portion of an amount received as an accumulation distribution was accumulated by the trust during years when the beneficiary was unborn, the beneficiary is not permitted to elect the limitation on tax provided by section 669(a)(1)(A).

Second method of limiting tax

The second method of limiting tax is provided by section 669(a)(1)(B). Under this method the beneficiary's gross income for the taxable year in which the accumulation distribution is paid, credited, or required to be distributed to him (determined without regard to the inclusion in income required by section 668(a) of any amount other than pursuant to section 669(a)(1)(B)) and for each of his 2 taxable years immediately preceding such year is recomputed solely for purposes of determining the limitation on the beneficiary's tax for the current year. The income for each of such 3 years is recomputed by adding thereto an amount determined by dividing the amount required to be included in income under section 668(a) by the number of preceding taxable years of the trust on the last day of each of which an amount is deemed under section 666(a) to have been distributed. There is then computed the increase in tax for each of such 3 years attributable to the increased amount of gross income. The aggregate of the increases in tax for such 3 years is divided by 3 to arrive at an

average increase in tax for such 3 years. This average increase in tax, multiplied by the number of preceding taxable years of the trust from the income of which the distribution is made, is the limitation on the beneficiary's tax liability (before the application of any credit for taxes paid by the trust allowed by sec. 668(b)) with respect to the accumulation distribution.

The computation made under the alternate election provided by section 669(a)(1)(B) is modified in two cases. When an accumulation distribution is deemed under section 666(a) to have been distributed on the last day of less than 3 taxable years of the trust, the taxable years of the beneficiary for which a recomputation is made under section 669(a)(1)(B) is limited to the number of years to which section 666(a) applies, commencing with the most recent taxable year of the beneficiary. Also, no recomputation of gross income is to be made for a beneficiary for a taxable year for which he was not alive on the last day thereof; and if the beneficiary has no preceding taxable year, the recomputation of gross income is made on the basis of his taxable year without regard to the inclusion in income required by section 668(a) of any amount other than pursuant to section 669(a)(1)(B).

The application of the preceding paragraph may be illustrated by the following examples: Assume that a foreign trust created by a U.S. person accumulates $3,000 of income for one year and $7,000 for a second year and then distributes the accumulated income on January 1, 1965, to a beneficiary who is a U.S. person. The limitation on tax computed under section 669(a)(1)(B) would be determined by recomputing the beneficiary's gross income for 1964 and 1965 by adding $5,000 to each year. If the same distribution were made to an infant who was born in 1965, the limitation on tax would be computed by adding $5,000 to his gross income for such year. The resulting increase in tax would be multiplied by 2 to arrive at the limitation on the increase in his tax for 1965 attributable to such distribution.

Effect of prior election

Section 669(a)(3) provides special rules which have application when a beneficiary who is a U.S. person receives a second or succeeding accumulation distribution from a foreign trust created by a U.S. person.

If a beneficiary has elected the limitation on tax provided by section 669(a)(1)(B) (the second method described herein) with respect to an accumulation distribution, and with respect to a subsequent accumulation distribution he desires to elect the limitation on tax provided by section 669(a)(1)(A) (the method provided by existing law), for purposes of computing the limitation on tax with respect to the subsequent accumulation distribution the income of any year with respect to which an amount is deemed distributed to a beneficiary under section 666(a) is to include amounts previously deemed distributed to such beneficiary for such year as a result of an accumulation distribution with respect to which an election under section 669(a)(1)(B) was made. The result of this rule is to require that for the purposes of computing the limitation on tax under section 669(a)(1)(A) with respect to an accumulation distribution, all previous elections are considered to have been made under section 669(a)(1)(A).

A special rule is also provided by section 669(a)(3) regardless of the limitation on tax elected with respect to a prior accumulation distribution when, with respect to a subsequent accumulation distribution, the limitation on tax provided by section 669(a)(1)(B) is elected by the beneficiary. When this occurs the number of preceding taxable years of the trust with respect to which an amount is deemed distributed to a beneficiary under section 666(a) is to be determined without regard to any such year with respect to which an amount was previously deemed distributed to such beneficiary.

(f) *Requirement of information return.*—Section 7(f) of the bill amends subpart B of part III of subchapter A of chapter 61 (relating to information concerning transactions with other persons) by adding a new section 6047.

SECTION 6047. RETURNS AS TO CREATION OF OR TRANSFERS TO CERTAIN FOREIGN TRUSTS

Section 6047 provides for the filing of an information return on or before the 90th day after the creation of any foreign trust by a U.S. person or after the transfer of any money or property to a foreign trust by a U.S. person. The return is to be in such form and is to set forth, in respect of the foreign trust, such information as the Secretary of the Treasury or his delegate prescribes by regulation as necessary for carrying out the provisions of the income tax laws. The return is required to be filed by the grantor in the case of an inter vivos trust, the fiduciary of an estate in the case of a testamentary trust, or by the transferor to a foreign trust, as the case may be.

(g) *Penalty for failure to file return.*—Section 7(g) of the bill amends subchapter B of chapter 68 (relating to assessable penalties) by adding a new section 6677.

SECTION 6677. FAILURE TO FILE INFORMATION RETURNS WITH RESPECT TO CERTAIN FOREIGN TRUSTS

Section 6677(a) provides that, in addition to any criminal penalty provided by law (such as the penalty provided by sec. 7203 for willful failure to file a return), any person required to file a return under section 6047 who fails to file such return at the time provided in such section, or who files a return which does not show the information required pursuant to such section, is to pay a penalty equal to 5 percent of the amount transferred to a trust, but not more than $1,000, unless it is shown that such failure is due to reasonable cause.

Section 6677(b) provides that the assessment or collection of any penalty imposed by section 6677(a) is not to be subject to the deficiency procedures provided by subchapter B of chapter 63 of the code.

(h) *Definitions.*—Section 7(h) of the bill amends section 7701(a) (relating to definitions) by adding paragraphs (30) and (31). Paragraph (30) defines the term "U.S. person" to mean an individual who is a citizen or resident of the United States; a domestic partnership; a domestic corporation; and any estate or trust (other than a foreign estate or foreign trust, within the meaning of sec. 7701(a)(31)). Paragraph (31) defines the terms "foreign estate" and "foreign trust" to mean an estate or trust, as the case may be, the income of which from sources without the United States is not includible in gross income under subtitle A of the code (relating to income taxes).

(i) *Technical amendments.*—Section 7(i) of the bill amends the tables of sections where necessary to reflect the addition of the new sections added by the bill.

(j) *Effective date.*—The amendments made by section 7 of the bill (other than by subsecs. (f), (g), and (h)) are to apply with respect to distributions made after the date of the enactment of the bill. The amendments made by subsections (f), (g), and (h) will take effect on such date of enactment.

SECTION 8. MUTUAL INSURANCE COMPANIES (OTHER THAN LIFE, MARINE, AND CERTAIN FIRE OR FLOOD INSURANCE COMPANIES), ETC.

(a) *Imposition of tax.*—Subsection (a) of section 8 of the bill, which corresponds to subsection (a) of section 10 of the bill as passed by the House, amends the heading and table of sections for part II of subchapter L of chapter 1 of the 1954 Code to conform them to the substantive changes made by the bill. In addition, subsection (a) in effect strikes out existing section 821 of the code and substitutes a new section 821, relating to the tax on mutual insurance companies to which part II applies.

SECTION 821. TAX ON MUTUAL INSURANCE COMPANIES TO WHICH PART II APPLIES

(a) *Imposition of tax.*—Subsection (a) of the new section 821 provides the general rule for taxing mutual insurance companies (including interinsurers and reciprocal underwriters). The tax will not apply to a mutual life insurance company, or to a mutual marine or mutual fire or flood insurance company subject to the tax imposed by section 831 of the 1954 Code. In addition, the tax will not apply if the alternative tax imposed by the new section 821(c) (relating to alternative tax for certain small companies) applies. Also, under subsection (d) of section 8 of the bill as amended by your committee, mutual insurance companies (other than life or marine) whose gross receipts (not including capital gains) for the taxable year do not exceed $150,000 will be exempt from tax under section 501(c)(15) of the 1954 Code.

The tax imposed by the new section 821(a) applies to each taxable year beginning after December 31, 1962. The tax is to consist of—

(1) a normal tax—

(A) in the case of taxable years beginning before July 1, 1963, of 30 percent of the mutual insurance company taxable income, or 60 percent of the amount by which such taxable income exceeds $6,000, whichever is the lesser; and

(B) in the case of taxable years beginning after June 30, 1963, of 25 percent of the mutual insurance company taxable income, or 50 percent of the amount by which such taxable income exceeds $6,000, whichever is the lesser; plus

(2) a surtax of 22 percent of the mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) in excess of $25,000.

Under existing law a mutual insurance company which is subject to the tax on investment income only is exempt from tax if its mutual

insurance company taxable income does not exceed $3,000. Similarly, existing law provides special notch relief if such a company has mutual insurance company taxable income between $3,000 and $6,000. Under the bill, companies having mutual insurance company taxable income (as defined in the new sec. 821(b)) which does not exceed $6,000 will be exempt from tax, and the special notch provision will apply if the company has mutual insurance company taxable income between $6,000 and $12,000.

(b) *Mutual insurance company taxable income defined.*—Subsection (b) of the new section 821 defines the term "mutual insurance company taxable income" for purposes of part II of subchapter L. Under this definition, mutual insurance company taxable income means the amount by which—

(1) the sum of—

(A) the taxable investment income (as defined in sec. 822(a)(1)),

(B) the statutory underwriting income (as defined in sec. 823(a)(1)), and

(C) the amounts required by section 824(d) to be subtracted from the protection against loss account, exceeds

(2) the sum of—

(A) the investment loss (as defined in sec. 822(a)(2)), if any,

(B) the statutory underwriting loss (as defined in sec. 823(a)(2)), if any, and

(C) the unused loss deduction provided by section 825(a).

If for any taxable year the amount determined under paragraph (2) of the new section 821(b) exceeds the amount determined under paragraph (1) of the new section 821(b), the mutual insurance company taxable income shall be zero.

(c) *Alternative tax for certain small companies.*—Paragraph (1) of the new section 821(c) provides an alternative tax which is in lieu of the tax imposed by section 821(a) for taxable years beginning after December 31, 1962. Except as provided in section 821(c)(3)(B), this tax applies in the case of every mutual insurance company described in section 821(c)(3)(A) and consists of—

(1) a normal tax—

(A) in the case of taxable years beginning before July 1, 1963, of 30 percent of the taxable investment income, or 60 percent of the amount by which such taxable income exceeds $3,000, whichever is the lesser; and

(B) in the case of taxable years beginning after June 30, 1963, of 25 percent of the taxable investment income, or 50 percent of the amount by which such taxable income exceeds $3,000, whichever is the lesser; plus

(2) a surtax of 22 percent of the taxable investment income (computed without regard to the deduction provided in sec. 242 for partially tax-exempt interest) in excess of $25,000.

Thus, paragraph (1) of the new section 821(c) provides, in effect, that certain small mutual insurance companies shall be taxed at regular corporate rates on taxable investment income only. Under the bill, such companies will continue to be taxed the same as under present law, except that the alternative 1-percent tax will not apply. Accordingly, if such a company has taxable investment income of less than $3,000, it is not subject to tax, and if the taxable investment income

is between $3,000 and $6,000, it is entitled to special notch relief. Unless such a company makes an election to be taxed under section 821(a), its underwriting gains or losses will not be taken into account for purposes of determining its tax liability.

Paragraph (2) of the new section 821(c), like section 821(c) of existing law, provides a special tax reduction for companies subject to tax under section 821. Your committee's amendments, however, provide for larger dollar amounts. Thus, if the gross amount received during the taxable year from the items described in section 822(b) (other than par. (1)(D) thereof) and premiums (including deposits and assessments) is over $150,000 but less than $250,000, the tax otherwise computed under paragraph (1) of section 821(c) is reduced to an amount which bears the same proportion to such tax as the excess over $150,000 bears to $100,000. Under the bill as passed by the House, if the gross amount received during the taxable year from items described in section 822(b) (other than par. (1)(D) thereof) and premiums (including deposits and assessments) was over $75,000 but less than $125,000, the tax otherwise computed under paragraph (1) of section 821(c) was reduced to an amount which bore the same proportion to such tax as the excess over $75,000 bore to $50,000. However, this special relief provision is to apply only to companies which are subject to the tax imposed by the new section 821(c) and is not to apply in the case of companies which are subject to the tax imposed by the new section 821(a).

Subparagraph (A) of the new section 821(c)(3) provides that, except as provided by section 821(c)(3)(B), every mutual insurance company (other than a life insurance company and other than a fire or flood or marine insurance company subject to the tax imposed by sec. 831) is to be subject to the tax imposed by section 821(c) if the gross amount received during the taxable year from the items described in section 822(b) (other than par. (1)(D) thereof) and premiums (including deposits and assessments) exceeds $150,000 but does not exceed $600,000. The $150,000 and $600,000 are amounts increased by your committee's amendments from amounts of $75,000 and $300,000, respectively, in the bill as passed by the House.

Subparagraph (B) of the new section 821(c)(3) provides that a mutual insurance company described in section 821(c)(3)(A) shall not be subject to the alternative tax imposed by section 821(c)(1) for the taxable year if there is in effect for the taxable year an election made by such company under section 821(d) to be taxable under section 821(a), of if there is any amount in the protection against loss account of such company at the beginning of the taxable year. Where the alternative tax treatment for certain small companies does not apply by reason of there being an amount in the protection against loss account at the beginning of the taxable year, the bill provides that an election may be made to subtract such amount from the protection against loss account as of the close of the preceding taxable year. (See sec. 824(d)(5).)

(d) *Election to include statutory underwriting income or loss.*—Paragraph (1) of the new section 821(d) provides that any mutual insurance company which is subject to the tax imposed by section 821(c) may elect to be subject to the tax imposed by section 821(a). Paragraph (2) provides that if the company makes such an election it shall be subject to the tax imposed by section 821(a) for the first taxable year for which the election is made and for all taxable years thereafter

unless the Secretary of the Treasury or his delegate consents to a revocation of such election. Under the bill, it is not intended to permit such companies an annual election to be taxed either under subsection (a) or (c) of the new section 821. However, there may be some situations where because of a substantial change in the character of the taxpayer's operations there would be an undue burden or material hardship if such taxpayer were not permitted to revoke its prior election. Under such circumstances, the bill provides that the election may be revoked with the consent of the Secretary of the Treasury or his delegate. If, however, for any taxable year for which the election would otherwise apply, the gross amount received by the company during the taxable year from the items described in section 822(b) (other than par. (1)(D) thereof) and premiums (including deposits and assessments) does not exceed $150,000, such election will terminate automatically. Thus, if for any taxable year after such a termination such a company has gross receipts from such sources of over $150,000 but not more than $600,000, it shall be subject to tax under section 821(c) unless it makes a new election to be taxed under section 821(a).

(e) *No U.S. insurance business.*—Subsection (e) of the new section 821 is identical with section 821(d) of existing law and provides that foreign mutual insurance companies (other than a life insurance company and other than a fire, flood, or marine insurance company subject to the tax imposed by sec. 831) not carrying on an insurance business within the United States are not to be subject to tax under part II of subchapter L but shall be taxable as other foreign corporations. (See sec. 881 of the code.)

(f) *Special transitional underwriting loss.*—Paragraph (1) of this subsection, for which there is no corresponding provision in the bill as passed by the House, provides a special transitional rule for determining the mutual insurance company taxable income of every mutual insurance company which has been subject to the tax imposed by this section (as in effect before enactment of this subsection) for the 6 taxable years immediately preceding January 1, 1963, and which has incurred an underwriting loss for at least 5 of such 6 taxable years.

Paragraph (2) of the new section 821(f) provides, for purposes of this part, that the mutual insurance company taxable income for the taxable year of a company described in paragraph (1) shall be the mutual insurance company taxable income for the taxable year (determined without regard to this subsection) reduced by the amount by which—

(A) the sum of the underwriting losses of such company for the 6 taxable years prior to January 1, 1963, reduced by the underwriting gain during such years, exceeds

(B) the total amount by which the mutual insurance company taxable income was reduced by reason of this subsection in prior taxable years.

Paragraph (3) of the new section 821(f) provides that for purposes of this subsection the term "underwriting loss" means the statutory underwriting loss, computed without any deduction under section 824(a), and that the term "underwriting gain" means statutory underwriting income, computed without any deduction under section 823(c) or any deduction under section 824(a).

Paragraph (4) of the new section 821(f) provides that this subsection shall only apply with respect to taxable years beginning after Decem-

ber 31, 1962, and before January 1, 1968, for which the taxpayer is subject to the tax imposed by section 821(a).

(g) *Cross-references.*—Subsection (g) of the new section 821, corresponding to subsection (f) of the bill as passed by the House, contains cross-references to section 501(c)(15) of the code (relating to exemption from tax of certain mutual insurance companies) and section 1201(a) (relating to alternative tax in case of capital gains).

SECTION 8. MUTUAL INSURANCE COMPANIES (OTHER THAN LIFE, MARINE, AND CERTAIN FIRE OR FLOOD INSURANCE COMPANIES), ETC. (Continued)

(b) *Taxable investment income.*—Subsection (b) of section 8 of the bill, which corresponds to subsection (b) of section 10 of the bill as passed by the House, contains technical amendments to sections 822 and 823 of the code. These amendments, in effect, retain the existing substantive provisions of section 822 but change the designation of the excess of gross investment income (as defined in sec. 822(b)) over gross investment deductions (as provided in sec. 822(c)) from "mutual insurance company taxable income" to "taxable investment income."

Subsection (b)(1) of section 8 of the bill changes the heading of section 822 to refer to taxable investment income and amends section 822(a) to define the terms "taxable investment income" and "investment loss" for purposes of part II of subchapter L. The investment loss is the excess of gross investment deductions over gross investment income.

Subsection (b)(2) of section 8 of the bill amends section 822(c) of the code (relating to deductions) and section 822(e) of the code (relating to foreign mutual insurance companies) by striking out the term "mutual insurance company taxable income" each place it appears and inserting in lieu thereof the term "taxable investment income". This amendment conforms to the amendment to section 822(a).

Subsection(b)(3) of section 8 of the bill amends section 822(c)(7) of the code (relating to special deductions) and provides that for purposes of paragraph (7) of section 822(c), in applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received), the reference in section 246(b) to "taxable income" is to be treated as a reference to "taxable investment income."

Subsection (b)(4) of section 8 of the bill redesignates section 823 of the code (relating to other definitions) as subsection (f) of the new section 822.

(c) *Statutory underwriting income or loss.*—Subsection (c) of section 8 of the bill, which corresponds to subsection (c) of section 10 of the bill as passed by the House, adds (after sec. 822(f), as redesignated by subsec. (b)(4) of sec. 8 of the bill) a new section 823, relating to determination of statutory underwriting income or loss, and a new section 824, relating to adjustments to provide protection against losses.

SECTION 823. DETERMINATION OF STATUTORY UNDERWRITING INCOME OR LOSS

(a) *In general.*—Paragraph (1) of the new section 823(a) defines the term "statutory underwriting income" for purposes of part II

of subchapter L. Under this definition, statutory underwriting income is the amount by which—

(1) the gross income which would be taken into account in computing taxable income under section 832 if the taxpayer were subject to the tax imposed by section 831, reduced by the gross investment income (as determined under sec. 822(b)), exceeds

(2) the sum of—

(A) the deductions which would be taken into account in computing taxable income if the taxpayer were subject to the tax imposed by section 831, reduced by the deductions provided in section 822(c) (relating to deductions in computing taxable investment income), plus

(B) the deductions provided in subsection (c) of the new section 823 (relating to special deduction for small company having gross amount of less than $1,200,000) and in section 824(a) (relating to deduction to provide protection against losses).

Thus, generally, the income of a company subject to tax under section 821(a) will be derived from the income as computed if it were subject to tax under section 831. For example, under existing law, mutual fire and casualty insurance companies must annually accrue all market discount attributable to the taxable year on bonds or securities which they hold. (See sec. 822(d)(2).) For purposes of computing taxable investment income this rule will continue to apply. However, since in computing statutory underwriting income, taxable investment income is subtracted from income determined as if the company were subject to tax under section 831, and since market discount is not required to be annually accrued by companies subject to the tax imposed by section 831, the effect is to understate what would otherwise be the statutory underwriting income by an amount equal to the amount of such accrual. Accordingly, the net effect under the bill, is that mutual fire and casualty insurance companies subject to the tax imposed under section 821(a) will treat market discount in the same manner as such item is presently treated in the case of a company subject to tax under section 831. In the case of a company subject to tax under section 831, any income attributable to market discount is subject to capital gains treatment at such time as the bond is sold or redeemed.

Paragraph (2) of the new section 823(a) provides that, for purposes of part II of subchapter L, the term "statutory underwriting loss" means the amount by which the amount referred to in paragraph (1)(B) of the new section 823(a) exceeds the amount referred to in paragraph (1)(A) of the new section 823(a).

Paragraphs (1) and (2) of the new section 823(a) provide, in effect, that for purposes of determining statutory underwriting income or loss for the taxable year a mutual insurance company subject to the tax imposed by section 821(a) must first take into account the same gross income and deduction items (except as modified by sec. 823(b)) as a taxpayer subject to tax under section 831 would take into account for purposes of determining its taxable income under section 832. These items are then reduced to the extent that they include amounts which are included in determining taxable investment income under section 822(a). In addition, the taxpayer is allowed a deduction for

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the amount determined under section 824(a) (relating to deduction to provide protection against losses) and, in the case of a company having gross receipts of less than $1,200,000, an additional deduction equal to the amount determined under section 823(c)(1), after the application of the limitation provided in section 823(c)(2).

(b) *Modifications.*—Subsection (b) of the new section 823 provides certain modifications to the general rule for determining statutory underwriting income or loss contained in section 823(a). Paragraph (1) of section 823(b) provides that for purposes of applying section 823(a), the deduction for net operating losses provided by section 172 is not to be allowed. (However, a company is allowed an unused loss deduction under the provisions of sec. 825.) Paragraph (2) of the new section 823(b) provides a special rule which applies in the case of an interinsurer or reciprocal underwriter which is subject to the tax imposed by section 821(a). This rule provides that if such a company, before the 16th day of the 3d month following the close of the taxable year, credits the individual account of each of its subscribers with an amount, representing savings to subscribers for the taxable year, which it would be obligated to pay promptly to such subscriber if he terminated his contract at the close of the company's taxable year, then—

(1) there is to be allowed as a deduction the increase for the taxable year in savings credited to subscriber accounts, or

(2) there is to be included as an item of gross income the decrease for the taxable year in savings credited to subscriber accounts.

Any amount representing savings credited to his account for the taxable year is to be treated by the subscriber as a dividend paid or declared for purposes of his taxable income. Thus, the amount of any savings credited to a subscriber within the meaning of this section shall be taken into account by him in computing his income to the extent that the cost of the insurance with respect to which the savings are credited constitutes a business expense.

(c) *Special deduction for small company having gross amount of less than $1,200,000.*—Subsection (c) of the new section 823 is identical to the bill as passed by the House, except for the increase in the gross amount provided by your committee's bill and relates to the special deduction for certain small companies having gross receipts of less than $1,200,000. Paragraph (1) of the new section 823(c) provides that if the gross amount received during the taxable year from the items described in section 822(b) (other than par. (1)(D) thereof) and net premiums (including deposits and assessments) is less than $1,200,000, then, subject to the limitation provided in paragraph (2) of the new section 823(c) there shall be allowed an additional deduction for purposes of determining statutory underwriting income or loss (under subsec. (a) of the new sec. 823) for the taxable year. This additional deduction is $6,000; except that if the gross amount exceeds $600,000, the additional deduction is limited to an amount equal to 1 percent of the amount by which $1,200,000 exceeds such gross amount. The special deduction provided by paragraph (1) does not apply if the taxpayer is either subject to the tax imposed by section 821(c) (relating to alternative tax for certain small companies) or has gross amounts of $1,200,000 or more.

Paragraph (2) of the new section 823(c) provides that the amount of the deduction allowed under paragraph (1) of the new section 823(c) is not to exceed the statutory underwriting income (as defined in sec. 823(a)(1)) for the taxable year, computed without regard to the deduction under paragraph (1) or the deduction allowed under section 824(a) (relating to deduction for protection against losses).

Example: The application of section 823(c) may be illustrated by the following example:

Company M, a mutual insurance company subject to the tax imposed by section 821(a), has the following items for the taxable year 1963:

Gross amount for purposes of sec. 823(c)(1)	$800,000
Gross investment income (including capital gains)	150,000
Capital gains	100,000
Gross income under sec. 832	900,000
Deductions under sec. 822(c)	142,000
Deductions under sec. 832 (as modified by sec. 823(b))	866,000

Under the provisions of section 823(c), company M's special small company deduction for the taxable year 1963 would be $4,000, computed as follows:

(1) Gross amount for purposes of sec. 823(c)(1)		$800,000
(2) Amount by which $1,200,000 exceeds item (1) ($1,200,000 minus $800,000)		400,000
(3) 1 percent of item (2), not to exceed $6,000		4,000
(4) Gross income under sec. 832, reduced by gross investment income ($900,000 minus $150,000)	$750,000	
(5) Deductions under sec. 832 (as modified by sec. 823 (b)), reduced by deductions under sec. 822(c) ($866,000 minus $142,000)	724,000	
(6) Limitation on deduction under sec. 823(c)(1) (excess, if any, of item (4) over item (5))		26,000
(7) Deduction under sec. 823(c)(1) (item (3) or item (6), whichever is the lesser)		4,000

SECTION 824. ADJUSTMENTS TO PROVIDE PROTECTION AGAINST LOSSES

(a) *Allowance of deduction.*—Paragraph (1) of the new section 824(a) provides that for purposes of determining the statutory underwriting income or loss (as defined in sec. 823(a)) for any taxable year there is to be allowed as a deduction to provide protection against losses the sum of—

(1) 1 percent of the losses incurred during the taxable year (as determined under sec. 832(b)(5)); plus

(2) 25 percent of the underwriting gain for the taxable year; plus

(3) if the concentrated windstorm, etc., premium percentage for the taxable year (as defined in par. (2) of the new sec. 824(a)) exceeds 40 percent, the amount determined by applying so much of the concentrated windstorm, etc., premium percentage as exceeds 40 percent to the underwriting gain for the taxable year.

This paragraph is the same as the corresponding provision under the bill as passed by the House, except that under your committee's amendments the excess of the premium percentage over 40 percent, instead of 50 percent, is used in determining that part of the protection against loss deduction provided by subparagraph (C).

For purposes of paragraph (1) of the new section 824(a), the term "underwriting gain" means the statutory underwriting income com-

puted under section 823(a) without regard to the deduction provided by paragraph (1) of the new section 824(a).

Subparagraph (C) of the new section 824(a)(1) permits an additional deduction for protection against losses in the case of certain companies having concentrated windstorm, etc., risks. For example, assume that for the taxable year 1963, W, a mutual insurance company subject to the tax imposed by section 821(a), has an underwriting gain (for purposes of sec. 824(a)) of $100. Assume further that W's concentrated windstorm, etc., premium percentage (as determined under sec. 824(a)(2)) for the taxable year is 70 percent, and losses incurred during the taxable year are $1,000. Under the provisions of section 824(a), W's deduction for protection against losses for 1963 would be $65. Of this amount, $10 (1 percent of losses incurred, or 1 percent of $1,000) is due to the application of section 824(a)(1)(A), $25 (25 percent of underwriting gain, or 25 percent of $100) is due to the application of section 824(a)(1)(B), and $30—the amount determined by multiplying the underwriting gain by so much of the concentrated windstorm, etc., premium percentage as exceeds 40 percent, or 30 percent (70 percent minus 40 percent) times $100—is due to the application of section 824(a)(1)(C).

Paragraph (2) of the new section 824(a) defines the term "concentrated windstorm, etc., premium percentage." This definition is changed from that of the bill as passed by the House only by the addition in the bill as reported of a provision for losses arising within a 200-mile radius of any point selected by the taxpayer. Thus, for any taxable year the percentage is obtained by dividing—

(1) the amount of the premiums earned on insurance contracts during the taxable year (as defined in sec. 832(b)(4)), to the extent attributable to insurance against losses arising either in any one State or within 200 miles of any fixed point selected by the taxpayer from windstorm, hail, flood, earthquake, or similar hazards, by

(2) the total amount of the premiums earned on insurance contracts during the taxable year (as defined in sec. 832(b)(4)).

The taxpayer may annually select, within the period of limitation allowed, any geographical area permitted by this paragraph. For example, a company located in Springfield, Ill., may in one year use as the numerator of the fraction the amount of premiums attributable to special insurance risks located within the State of Illinois; in the second year the amount of premiums attributable to such insurance risks located within 200 miles of Peoria; and in the third year the amount of premiums attributable to such insurance risks located within 200 miles of Cedar Rapids, Iowa. For purposes of this paragraph, the term "similar hazards" includes tornadoes, cyclones, and similar natural phenomena but does not include insurance against fires, explosions, or riots. In the case of a company which issues contracts insuring against a combination of risks, some of which are included under this paragraph and some of which are not included under this paragraph, a reasonable allocation of the premiums earned for the taxable year with respect to such contracts will be made for purposes of determining such company's concentrated windstorm, etc., premium percentage for the taxable year.

(b) *Protection against loss account.*—Subsection (b) of the new section 824 requires every insurance company subject to the tax imposed by section 821(a) for any taxable year to establish and maintain a

protection against loss account. This account is to be established for taxable years beginning after December 31, 1962, and the beginning or opening balance of such account is to be zero.

(c) *Additions to account.*—Subsection (c) of the new section 824 relates to the amount which is to be added to the protection against loss account for each taxable year for which the taxpayer is subject to the tax under section 821(a). Subsection (c) of the new section 824 provides that the amount to be added to the protection against loss account is to be an amount equal to the deduction for protection against losses provided by section 824(a)(1).

(d) *Subtractions.*—Paragraphs (1), (4), and (5) of the new section 824(d) sets forth the amounts which are to be subtracted from the protection against loss account. The amount which is required to be subtracted under section 824(d) is taken into account under section 821(b)(1)(C) for purposes of determining mutual insurance company taxable income. Except for the amendments described below, the subtractions required under your committee's bill are identical with those provided in the bill as passed by the House.

Paragraph (1) of the new section 824(d) provides that, after making the additions required by section 824(c) for the taxable year, there shall be subtracted from the protection against loss account—

(A) first, an amount equal to the excess (if any) of the protection against loss deduction allowed under section 824(a) for the taxable year over the underwriting gain (as defined in sec. 824(a)(1)) for the taxable year,

(B) then, the amount (if any) by which—

(i) the sum of the investment loss for such year and the statutory underwriting loss (reduced by the amount referred to in subpar. (A)) for such year, exceeds

(ii) the sum of the statutory underwriting income and the taxable investment income for such taxable year,

(C) next (in the order in which the losses occurred), amounts equal to the unused loss carryovers to such taxable year,

(D) next, any amount remaining which was added to the account for the fifth preceding taxable year, minus one-half of underwriting gain remaining in the account for such taxable year which was added under subsection (a)(1)(B), and

(E) finally, the amount by which the total amount in the account exceeds whichever of the following is the greater:

(i) 10 percent of premiums earned on insurance contracts during the taxable year (as defined in sec. 832(b)(4)) less dividends to policyholders (as defined in sec. 832(c)(11)), or

(ii) the total amount in the account at the close of the preceding taxable year.

Under the bill as passed by the House, subparagraph (A) of the new section 824(d)(1) provided that the first subtraction from the protection against loss account was to have been made for so much of the statutory underwriting loss as was generated either by the deduction for dividends to policyholders (as defined in sec. 832(c)(11)) or by the deduction provided in section 824(a) for protection against losses. Thus, under the bill as passed by the House, any underwriting loss which was attributable to the payment of policy dividends could not be applied against taxable investment income unless the balance in the protection against loss account had first been reduced to zero.

Your committee has amended subparagraphs (A) and (B) to provide in effect that any portion of the statutory underwriting loss which is attributable to the deduction for dividends to policyholders may first be applied against taxable investment income. Under your committee's amendments, however, no portion of the statutory underwriting loss which is attributable to the deduction for protection against losses provided in section 824(a) may be applied against taxable investment income since it is applied against the balance in the protection against loss account.

Under subparagraph (B) of the new section 824(d)(1), the statutory underwriting loss is subtracted from the protection against loss account but only to the extent that such loss exceeds the taxable investment income and the amount determined under subparagraph (A) for the taxable year. The adjustment for the amount subtracted under subparagraph (A) is required by reason of your committee's amendment to subparagraph (A), and prevents the same item from being subtracted from the protection against loss account more than once. In addition, subparagraph (B) provides that where there is an investment loss for the taxable year such loss must first be applied against statutory underwriting income and then any remaining amount must be applied against any balance in the protection against loss account. Or, if there is both a statutory underwriting loss after the reduction referred to in subparagraph (A) and an investment loss, the sum of these losses must be so applied. Only then may any remaining amount give rise to an unused loss.

Subparagraph (D) of the new section 824(d)(1) provides for the subtraction of certain amounts added to the protection against loss account for any taxable year under section 824(c) if such amounts remain in the account for 5 taxable years. Under subparagraph (D) of the new section 824(d), the entire amount remaining in the account from the fifth preceding taxable year which was added by reason of section 824(a)(1)(A) (relating to deduction for 1 percent of losses incurred during the taxable year) or section 824(a)(1)(C) (relating to additional deduction for certain companies having concentrated windstorm, etc., risks) is to be subtracted from the protection against loss account. There is also to be subtracted under subparagraph (D) of the new section 824(d)(1) an amount representing one-half of the amount remaining in the account with respect to such fifth preceding taxable year which was added by reason of section 824(a)(1)(B) (relating to deduction for 25 percent of underwriting gain for the taxable year). (For a special rule with respect to a reciprocal making the election provided in sec. 826(a), see sec. 826(d).)

Subparagraph (E) of the new section 824(d)(1) provides (taking into account the priority rule in sec. 824(d)(3)(B)), in effect, a ceiling on the amount which can be added to and remain in the protection against loss account for the taxable year for which the amount is added. Subparagraph (E) provides that if the total amount in the account (as determined under sec. 824(d)(2)) exceeds the greater of (1) 10 percent of premiums earned on insurance contracts during the taxable year (as defined in sec. 832(b)(4)) less dividends to policyholders (as defined in sec. 832(c)(11)), or (2) the total amount in the account at the close of the preceding taxable year, then the amount of such excess shall be subtracted from the protection against loss account.

Paragraph (2) of the new section 824(d) contains rules for determining the ceiling on the protection against loss account. It provides

that for purposes of paragraph (1)(E) of the new section 824(d), the total amount in the account is to be determined—

(1) after the application of section 824(d) without regard to paragraph (1)(E) thereof, and

(2) without regard to amounts remaining in the account which were added, with respect to all taxable years, under section 824(a)(1)(C) (relating to additional deduction to provide protection against losses for certain companies having concentrated windstorm, etc., risks).

Under paragraph (2) of the new section 824(d), for purposes of determining the ceiling on the protection against loss account in the case of a company having concentrated windstorm, etc., risks, any amount added to the account by reason of the application of section 824(a)(1)(C) is not to be taken into account.

Paragraph (3) of the new section 824(d) provides rules relating to the priority in which the subtractions from the protection against loss account are to be made. Under paragraph (3)(A) of the new section 824(d) the amounts required to be subtracted from the protection against loss account under section 824(d)(1) (A), (B), and (C), are to be made—

(1) first (on a first-in, first-out basis) from amounts in the account with respect to the 5 preceding taxable years and the taxable year, and

(2) then from amounts in the account with respect to earlier years.

Under paragraph (3)(B) of the new section 824(d), the amounts required to be subtracted from the protection against loss account under section 824(d)(1)(E) are to be subtracted only from amounts in the account with respect to the taxable year.

Under paragraph (3)(C) of the new section 824(d), if the amount to be subtracted from the total amounts in the account with respect to any taxable year is less than such total, the amount required to be subtracted from the protection against loss account under section 824(d)(1) (A), (B), (C), and (E) is to be subtracted from each of the amounts referred to in section 824(a)(1) in the account with respect to such year in the proportion which each bears to the total amount in the account with respect to such year. For example, assume that for the taxable year 1966, N, a mutual insurance company subject to the tax imposed by section 821(a), is required to subtract \$60 from its protection against loss account under section 824(d)(1) (other than under subpar. (E)). Assume that the total amount in the account for 1963 (the first preceding taxable year for which additions to the account were made) is \$100. Assume further that of this \$100 balance, \$30 is due to the application of section 824(a)(1)(A), \$50 is due to the application of section 824(a)(1)(B), and \$20 is due to the application of section 824(a)(1)(C). Under paragraph (3)(C) of the new section 824(d), since the amount to be subtracted from the balance in the account with respect to 1963 is less than such balance, the amount to be subtracted from each of the amounts in the account with respect to such taxable year shall be in the proportion which each bears to such total. Accordingly, the amount in the account by reason of the application of section 824(a)(1)(A) shall be reduced by \$18 (30/100×\$60). The amount in the account with respect to the application of section 824(a)(1)(B) shall be reduced by \$30

(50/100×$60). The amount in the account with respect to the application of section 824(a)(1)(C) shall be reduced by $12 (20/100×$60).

Paragraph (4) of the new section 824(d) provides that if the taxpayer is not subject to tax under part II of subchapter L for any taxable year, the entire amount in the protection against loss account at the close of the preceding taxable year is to be subtracted from the account in such preceding taxable year and included in mutual insurance company taxable income (as defined in sec. 821(b)) for such preceding taxable year.

Paragraph (5) of the new section 824(d) provides that for any taxable year for which the company is subject to the tax imposed by section 821(a), it may elect to subtract from its protection against loss account any amount which, except for the application of this election, would be in such account as of the close of such taxable year. The amount elected to be subtracted from the protection against loss account is to be included in mutual insurance company taxable income (as defined in sec. 821(b)) for the taxable year. The election must be made after the close of the taxable year for which it is to apply and not later than the time prescribed by law for filing the return (including extensions thereof) for the taxable year following such taxable year, and in such manner and form as the Secretary of the Treasury or his delegate may by regulations prescribe. The election is to apply only with respect to the taxable year for which it is made and once such an election has been made it may not subsequently be revoked.

Examples.—The application of new section 824(d) may be illustrated by the following examples:

Example 1.—For the taxable year 1969, X, a mutual insurance company subject to the tax imposed by section 821(a), has taxable investment income of 25 and a statutory underwriting loss of 22 (including a protection against loss deduction of 7 which is entirely attributable to the application of sec. 824(a)(1)(A)). The following table shows the protection against loss account of X before and after the application of section 824(d) for the taxable year 1969:

	1963	1964	1965	1966	1967	1968	1969
Protection against loss account: Balance remaining in account with respect to each taxable year (before application of sec. 824(d))	3	1	1	1	2	1	7
Balance remaining in account with respect to each taxable year (after application of sec. 824(d))	3	0	0	0	0	0	6

Under the provisions of section 824(d)(1)(A), for the taxable year 1969, X would subtract 7 from its protection against loss account (the amount by which the protection against loss deduction allowed under sec. 824(a) for the taxable year exceeds the underwriting gain for the taxable year, or 7 minus 0). Under the provisions of section 824(d)(3)(A), since the subtractions are to be made with respect to amounts in the account for the 5 preceding taxable years and the taxable year on a first-in, first-out basis, X would first apply the amount to be subtracted to the amount in the account with

respect to 1964, 1965, 1966, 1967, and 1968, in that order. This would reduce the total amount in the account with respect to such taxable years by 6, and the balance in the account with respect to each of the taxable years 1964 through 1968 would be reduced to zero. The remaining amount required to be subtracted under section 824(d)(1)(A), 1 (7 minus 6), would then be subtracted from the amount added to the account for the taxable year, 7 (an amount equal to the protection against loss deduction for the taxable year 1969), leaving a balance of 6 (7 minus 1) in the account with respect to 1969. No proration of the subtraction from the amount in the account for 1969 is required under section 824(d)(3)(C) since the entire amount added to the account in 1969 was added by reason of section 824(a)(1)(A).

Example 2.—Assume the facts are the same as in example 1, except that X has taxable investment income of 7 (instead of 25) for the taxable year 1969. After the application of section 824(d) for the taxable year 1969, the results would be as follows:

Protection against loss account

	1963	1964	1965	1966	1967	1968	1969
Balance remaining in account with respect to each taxable year (after application of sec. 824(d))	1	0	0	0	0	0	0

Under the provisions of section 824(d)(1), for the taxable year 1969, X would subtract 15 from its protection against loss account. Of this amount, 7 would be attributable to the application of section 824(d)(1)(A) (i.e., the amount by which the protection against loss deduction allowed under sec. 824(a) for the taxable year exceeds the underwriting gain for the taxable year, or 7 minus 0), and 8 would be attributable to the application of section 824(d)(1)(B) (i.e., the amount by which the statutory underwriting loss for the taxable year, reduced by the amount determined under sec. 824(d)(1)(A), exceeds the taxable investment income for the taxable year, or the amount by which 15 (22 minus 7) exceeds 7). Under section 824(d)(3)(A)(i), this subtraction would be made (on a first-in, first-out basis) from amounts in the account with respect to 1964, 1965, 1966, 1967, 1968, and 1969, in that order. This would reduce the total amount in the account with respect to such taxable years by 13, and the balance in the account with respect to each of the taxable years 1964 through 1969 would be reduced to zero. Under the provisions of section 824(d)(3)(A)(ii), the remaining amount required to be subtracted under section 824(d)(A), 2 (15 minus 13), would then be subtracted from the amount in the account with respect to 1963 (i.e., the amount representing one-half of the amount added by reason of sec. 824(a)(1)(B) which was not required to be subtracted from the protection against loss account under sec. 824(d)(1)(D) in 1968). Thus, the amount in the account with respect to 1963 would be reduced to 1 (3 minus 2).

Example 3.—Assume that Y, a mutual insurance company subject to tax under section 821(a), has a protection against loss account

which reflects the following items for the taxable years 1963 through 1968:

Additions to protection against loss account

	1963	1964	1965	1966	1967	1968
Additions:						
1 percent of losses incurred	15	20	60	60	60	60
25 percent of underwriting gain	60	20	40	50	45	45
Additional deduction for concentrated risks	0	0	5	5	0	0
Total	75	40	105	115	105	105

Y, in computing mutual insurance company taxable income for 1968, is required to subtract from the account with respect to 1963 the entire amount of the 1 percent of losses incurred added for 1963 (15) and one-half of the underwriting gain (30) added for such year. Upon taking into account these subtractions, the balance in the protection against loss account with respect to 1963 is 30 (the one-half remaining in the account after the application of par. (1)(D) of sec. 824(d)).

Assume further, that for the taxable year 1969, Y has taxable investment income of 50, underwriting gain of 80, resulting because of incurred losses of 4,000, expenses of 1,000, and premiums earned less dividends to policyholders of 5,080. Under section 824(a), the protection against loss deduction for 1969 is 60. After applying section 824(c), but before applying section 824(d) for 1969, the protection against loss account as of the close of 1969 (after subtracting in 1968 the 45 amount with respect to 1963) would be as follows:

Protection against loss account

	1963	1964	1965	1966	1967	1968	1969
Additions:							
1 percent of loss incurred	0	20	60	60	60	60	40
25 percent of underwriting gain	30	20	40	50	45	45	20
Additional deduction for concentrated risks	0	0	5	5	0	0	0
Total with respect to taxable year	30	40	105	115	105	105	60
Total (as of end of each year before 1969 subtractions)	30	70	175	290	395	500	560

After making the addition to the protection against loss account for 1969 and obtaining the results shown in the table above, Y is required to make the subtractions for 1969 from the account. These subtractions may be summarized as follows:

Subtractions under section 824(d) for 1969

Taxable year with respect to which amount is subtracted	1963	1964	1965	1966	1967	1968	1969
Par. (1)(A) subtraction	0	0	0	0	0	0	0
Par. (1)(B) subtraction	0	0	0	0	0	0	0
Par. (1)(C) subtraction	0	0	0	0	0	0	0
Par. (1)(D) subtraction	0	[1] 30	0	0	0	0	0
Par. (1)(E) subtraction	0	0	0	0	0	0	12
Pars. (4) and (5) subtraction	0	0	0	0	0	0	0

[1] 20 represents the amount added for 1964 with reference to incurred losses; 10 represents one-half of the amount added for 1964 with reference to underwriting gain.

After determining the subtractions with respect to years before 1969, the next step is to determine whether any subtraction is required for the taxable year 1969 under section 824(d)(1)(E). Since the total balance in the account after the application of section 824(d) (other than par. (1)(E) thereof), 520 (560 minus 30, and excluding 10 added to the account by reason of the additional deduction for protection against losses for concentrated windstorm, etc., companies provided by sec. 824(a)(1)(C)), exceeds 10 percent of premiums earned on insurance contracts during the taxable year less dividends to policyholders, 508 (10 percent of 5,080), Y would be subject to the ceiling on the protection against loss account for the taxable year 1969 and would be required to subtract 12 (the excess of 520 over 508) from the account under section 824(d)(1)(E). Under the provisions of section 824(d)(3)(B) this subtraction would be made only from amounts in the account with respect to the taxable year 1969. Under the provisions of section 824(d)(3)(C), however, since the amount to be subtracted, 12, is less than the total amount added to the account for the taxable year, 60 (40 plus 20), the subtractions under section 824 (d)(1)(E) would be applied ratably against each of the amounts added to the account for the taxable year. Thus, the amount remaining in the account with respect to section 824(a)(1)(A) for the taxable year 1969, would be 32 (40 minus $40/60 \times 12$, or 40 minus 8), and the amount remaining in the account with respect to section 824(a)(1)(B) for the taxable year 1969, would be 16 (20 minus $20/60 \times 12$, or 20 minus 4).

Based on these facts, Y's mutual insurance company taxable income for 1969 would be 112 (the sum of taxable investment income of 50, plus statutory underwriting income of 20 (underwriting gain minus protection against loss deduction, or 80 minus 60), plus subtractions from the protection against loss account under sec. 824(d) of 42).

SECTION 825. UNUSED LOSS DEDUCTION

(a) *Amount of deduction.*—Subsection (a) of the new section 825 provides that, for purposes of part II of subchapter L, the unused loss deduction (used in the determination of mutual insurance company taxable income under sec. 821(b)) shall be an amount equal to the unused loss carryovers and carrybacks to the taxable year.

(b) *Unused loss defined.*—Subsection (b) of the new section 825 defines the term "unused loss," for purposes of part II of subchapter L, as the amount by which—

(1) the sum of the statutory underwriting loss (as defined in sec. 823(a)(2)) and the investment loss (as defined in sec. 822(a)(2)), exceeds—

(2) the sum of—

(A) the taxable investment income (as defined in sec. 822(a)(1)),

(B) the statutory underwriting income (as defined in sec. 823(a)(1)), and

(C) the amounts required to be subtracted from the protection against loss account under section 824(d).

If the sum of the items under (1) does not exceed the sum of items under (2), the unused loss is zero.

(c) *Loss year defined.*—Subsection (c) of the new section 825 defines as the loss year, for purposes of part II of subchapter L, any taxable year in which a company subject to the tax imposed by section 821(a) has an unused loss which is more than zero.

(d) *Years to which carried.*—Subsection (d) provides that the unused loss for any loss year is to be an unused loss carryback to each of the 3 taxable years preceding the loss year and an unused loss carryover to each of the 5 taxable years following the loss year. (For certain taxable years to or from which an unused loss may not be carried, see section 825(g).)

(e) *Amount of carrybacks and carryovers.*—Subsection (e) of the new section 825 provides that for any loss year, the entire amount of the unused loss, determined under the provisions of section 825(b), shall be carried to the earliest of taxable years to which such loss may be carried under section 825(d) (subject to the limitations of sec. 825(g)). The amount of the unused loss carried to each of the other taxable year (permitted under section 825(d)), following the earliest taxable year shall be the excess of such loss over the sum of the offsets for each taxable year preceding the taxable year to which the loss is carried.

(f) *Offset defined.*—Subsection (f) of the new section 825 defines the term "offset," for purposes of section 824(e) and provides that the taxable year to which an unused loss is carried is to be referred to as the "offset year." "Offset" is defined as the mutual insurance company taxable income for the offset year in the case of an unused loss carryback from the loss year to the offset year. In the case of an unused loss carryover from the loss year to the offset year, the offset is the sum of the amount required to be subtracted from the protection against loss account under section 824(d)(1)(C) for the offset year and the mutual insurance company taxable income for the offset year. For purposes of computing the offset, the mutual insurance company taxable income for the offset year (as defined in sec. 821(b)) shall be determined without regard to any loss carryback or carryover to the offset year from the loss year, or any year thereafter.

Example: The application of section 825 may be illustrated by the following example:

For the taxable year 1967, F, a mutual insurance company subject to the tax imposed by section 821(a), has the following items:

Taxable investment income	1
Underwriting loss	59
Addition to protection against loss account	8
Statutory underwriting loss	67

As explained below, the subtractions from protection against loss account are as follows:

Amount subtracted from amounts in account with respect to taxable years 1963 through 1966	18
Amount subtracted from amounts in account with respect to taxable year 1967	8
Total subtractions from protection against loss account under sec. 824(d)	26

The application of section 825 in this case may be illustrated by the facts and results shown in the following table and explained below:

	Taxable year—					
	1963	1964	1965	1966	1967	1968
Protection against loss account:						
Addition to account during taxable year	6	2	3	7	8	7
Subtraction from account during taxable year	0	0	0	0	8	7
Protection against loss account (at end of year)	6	2	3	7	0	0
Protection against loss account (at end of taxable year 1968)	0	0	0	0	0	0
Unused loss	0	0	0	0	40	0
Unused loss carryback	0	40	35	25	0	0
Unused loss carryover	0	0	0	0	0	18
Unused loss deduction	0	40	35	25	0	18
Mutual insurance company taxable income (computed without regard to unused loss)	13	5	10	7	0	2
Mutual insurance company taxable income (computed with regard to unused loss)	13	0	0	0	0	0
Offset for year	0	5	10	7	0	9
Offset total	0	5	15	22	0	31

1967: Under the provisions of section 825(b), F's unused loss for 1967 is 40, the amount by which the sum of the statutory underwriting loss and the investment loss, 67 (67 plus 0), exceeds the sum of the taxable investment income, the statutory underwriting income, and the amounts required to be subtracted from the protection against loss account under section 824(d) for the taxable year, 27 (the sum of 1, 0, and 26, respectively).

1967 carryback to 1964: Under the provisions of section 825(e), the entire unused loss for 1967 of 40 is carried back to 1964, the earliest year to which the loss may be carried under section 825(d). Since there are no other amounts carried to 1964, the unused loss deduction for 1964 is 40. Thus, after taking the unused loss deduction into account, the mutual insurance company taxable income for 1964 is zero, and the offset for 1964 is 5 (the mutual insurance company taxable income for 1964 determined without regard to the unused loss carryback from 1967 or any year thereafter).

1967 carryback to 1965: The portion of the unused loss for 1967 which is carried back to 1965 is 35 (40 minus 5, the offset for 1964). After taking the underwriting loss deduction into account, the mutual insurance company taxable income for 1965 is zero. The offset for 1965 is 10, the mutual insurance company taxable income for 1965 determined without regard to any unused loss carryback or carryover from 1967 or any year thereafter.

1967 carryback to 1966: The portion of the unused loss for 1967 which is carried back to 1966 is 25. This amount is the excess of the underwriting loss for 1967 of 40 over the sum of the offset for 1965 (5) and the offset for 1966 (10). Thus, as a result of the unused loss for 1967, the mutual insurance company taxable income for 1966 is reduced to zero. The offset for 1966 is 7.

1967 carryover to 1968: Under the provisions of section 825(d), the portion of the unused loss for 1967 which is carried forward to 1968 is 18 (40 minus the sum of 10, 5, and 7, the offsets for 1964, 1965, and 1966, respectively). Under section 825(f)(2), this amount is first applied against any amounts in the protection against loss account at the end of 1968, and is then applied against the mutual insurance company taxable income for 1968. Thus, assuming that there are

no other subtractions from its protection against loss account under section 824(d) for 1968, F's protection against loss account of 7 is reduced to zero by reason of the subtraction under section 824(d)(1)(C). The remaining portion of the unused loss for 1967 which is carried to 1968, 11 (18 minus 7, the amount of the unused loss carryover to 1968 which is subtracted from the protection against loss account under sec. 824(d)(1)(C)), is then applied against the mutual insurance company taxable income for 1968. Thus, after the application of the unused loss deduction for 1968, the mutual insurance company taxable income for 1968 is zero. The offset for 1968 is 9, the sum of the amount required to be subtracted from the protection against loss account under section 824(d)(1)(C) for 1968 (7), plus the mutual insurance company taxable income for 1968, determined without regard to the unused loss carryover from 1967 or any unused loss carryback from 1967 or any year thereafter (2). The remaining 9 of the unused loss for 1967 (40 minus the sum of 10, 5, 7, and 9, the offsets for 1964, 1965, 1966, and 1968, respectively), is carried forward to 1969, and to the extent not used in that year or any year thereafter, may be carried forward to 1970, 1971, and 1972, in that order.

(g) *Limitations.*—Subsection (g) of the new section 825 provides that, for purposes of part II of subchapter L, an unused loss (as defined in sec. 825(b)) may not be carried—

(1) to or from any taxable year beginning before January 1, 1963;

(2) to or from any taxable year for which the insurance company is not subject to tax imposed by section 821(a); nor

(3) to any taxable year if, between the loss year and such taxable year, there is an intervening taxable year for which the insurance company was not subject to the tax imposed by section 821(a).

Examples.—The application of section 825(g) may be illustrated by the following:

Example 1.—For the taxable year 1963, M, a mutual insurance company subject to tax imposed by section 821(a), has an unused loss (as defined in sec. 825(b)) of $65,000. The loss may not be carried back to any taxable year beginning before 1963. However, the loss may be carried forward to each of the 5 taxable years following 1963 provided that for each of such succeeding taxable years M is subject to the tax imposed by section 821(a).

Example 2.—Assume the facts are the same as in example 1, except that for the taxable year 1964, the gross amount received by M from the items described in section 822(b) (other than par. (1)(D) thereof) and premiums (including deposits and assessments) exceeds $150,000 but does not exceed $600,000. If M does not make the election under section 821(d) (relating to election to be taxed under sec. 821(a) for 1964), the loss will not be allowed as an unused loss carryover since, by reason of section 825(g)(3), the unused loss may not be carried to any taxable year if, between the loss year and such taxable year, there is an intervening taxable year for which the insurance company was not subject to the tax imposed by section 821(a), and by reason of section 825(g)(1), the unused loss may not be carried to any taxable year beginning before 1963.

SECTION 826. ELECTION BY RECIPROCAL

(a) *In general.*—Subsection (a) of the new section 826 provides that, except as provided in section 826(c), any insurance company which is an interinsurer or reciprocal underwriter (referred to in sec. 826 as a "reciprocal") subject to the tax imposed by section 821(a), may elect to be subject to the limitation provided in subsection (b) of the new section 826. Such election shall be made, under regulations prescribed by the Secretary of the Treasury or his delegate, not later than the time prescribed by law (including extensions thereof) for filing the return for the year for which such election is first to apply. The election is to apply for the taxable year for which made and for all succeeding taxable years and may not be revoked without the consent of the Secretary of the Treasury or his delegate. The effect of such election is to increase the income of the reciprocal by the income of its attorney-in-fact attributable to the reciprocal for purposes of computing the taxes imposed by section 821(a) and to allow such reciprocal a credit for the taxes paid by the attorney-in-fact with respect to the income attributed to the reciprocal.

(b) *Limitation.*—Subsection (b) of the new section 826 provides that a reciprocal making the election provided under section 826(a) shall limit the deduction for amounts paid or incurred in the taxable year to the attorney-in-fact to such amounts as are deductible by the attorney-in-fact in respect of the income received by the attorney-in-fact from the reciprocal. In no case may such deduction of the reciprocal be increased by the deductions of the attorney-in-fact allocable to the income received from the reciprocal.

(c) *Exception.*—Section 826(c) provides that no election under section 826(a) may be made by a reciprocal unless its attorney-in-fact—

(1) is a corporation subject to the taxes imposed by section 11 (b) and (c) of subtitle A;

(2) consents to make available such information as may be required during the period in which an election made under subsection (a) is in effect;

(3) reports income received from the reciprocal and deductions allocable thereto under the same method of accounting used by the reciprocal in reporting deductions for amounts paid or incurred to the attorney-in-fact; and

(4) files its return on a calendar-year basis.

(d) *Special rule.*—Under the bill as passed by the House, the limitation under section 826(b) would not have been taken into account by any reciprocal electing under section 826(a) either for purposes of computing the protection against loss deduction provided in section 824(a) or for purposes of computing the addition to the protection against loss account provided in section 824(c). Thus, in effect, a reciprocal making the election would not have included any of the income of the attorney-in-fact in computing its protection against loss deduction. Your committee has amended this section to provide that the protection against loss deduction, and the amount added to the protection against loss account, for the taxable year, may be increased to reflect any amounts attributable to the consolidation permitted under this subsection. However, your committee has provided a special rule that in applying section 824(d)(1)(D) any amount which was added to the protection against loss account by

reason of such an election shall be treated as having been added by reason of section 824(a)(1)(A). The effect of this special rule is that no portion of the amount added to the protection against loss account by reason of the election under section 826(a) (i.e., the amount by which 25 percent of consolidated underwriting income exceeds 25 percent of underwriting income determined prior to consolidation), may be deferred for more than 5 years.

(e) *Credit.*—Subsection (e) of the new section 826 provides that any reciprocal electing to be subject to the limitation provided in subsection (b) shall be credited with the tax paid by its attorney-in-fact with respect to the income of the reciprocal in such taxable year.

(f) *Surtax exemption denied.*—Subsection (f) of the new section 826 provides that any tax imposed upon the increase in the income of the reciprocal attributable to the limitation under subsection (b) shall be computed without regard to the $25,000 surtax exemption provided in section 821(a)(2).

(g) *Adjustment for refund.*—Subsection (g) of the new section 826 provides that if for any taxable year an attorney-in-fact is allowed a credit or refund for taxes paid with respect to which a reciprocal was allowed a credit or refund as a result of the application of subsection (e) of the new section 826, the taxes of the reciprocal for the year in which such credit or refund is allowed shall be properly adjusted under regulations prescribed by the Secretary of the Treasury or his delegate. This adjustment prevents the reciprocal and the attorney-in-fact from obtaining a credit or refund with respect to the same tax.

For example, assume that a reciprocal has elected in 1963 to be subject to the limitation provided in section 826(b) and such election is still in effect in taxable year 1966. Assume further that in taxable year 1969 its attorney-in-fact receives a refund or credit with respect to taxable year 1966. In such case, the taxes of the reciprocal in taxable year 1969 shall be properly adjusted under regulations prescribed by the Secretary of the Treasury or his delegate.

(h) *Taxes of attorney-in-fact unaffected.*—Subsection (h) of the new section 826 provides that nothing in section 826 shall either increase or decrease the taxes imposed by chapter 1 on the income of the attorney-in-fact.

Example.—The application of section 826 may be illustrated by the following example:

For the taxable year 1963, R, a reciprocal underwriter subject to the taxes imposed by section 821(a), has the following items (determined before applying any election under sec. 826):

Gross income under sec. 832		$578
Gross investment income		50
Deductions under sec. 832 (as modified by sec. 823(b)):		
Deduction for amounts paid by R to attorney-in-fact A	**$100**	
All other deductions	**500**	
Total deductions under sec. 832	**600**	
Deductions under sec. 822(c)		**40**
Incurred losses		**400**
Protection against loss deduction		**4**
Underwriting gain		**0**
Mutual insurance company taxable income		**0**
Unused loss		**22**
Credit or refund for taxes paid		**0**

Assume that the deductions of attorney-in-fact A allocable to the income received by A from R are 60 and the tax paid by A allocable to the income received from R is 16. If R elects to be subject to the limitation provided in section 826(b), the results for 1963 would be as follows:

Gross income under sec. 832		578
Gross investment income		50
Deductions under sec. 832 (as modified by sec. 823(b)):		
Deduction for amounts paid by R to attorney-in-fact A	60	
All other deductions	500	
Total deductions under sec. 832	560	
Deductions under sec. 822(c)		40
Incurred losses		400
Protection against loss deduction		6
Underwriting gain		8
Mutual insurance company taxable income		12
Unused loss		0
Credit or refund for taxes paid		16

Under the provisions of section 826(b), R's deduction for amounts paid or incurred to the attorney-in-fact in the taxable year 1963 would be limited to the deductions of A allocable to the income received by A from R. Thus, R's deductions under section 832 (as modified by sec. 823(b)) for 1963 would be 60 (the deductions of A which are allocable to the income received by A from R). As a result of making the election under section 826(a) for the taxable year 1963, R's underwriting gain would be 8, and its statutory underwriting income would be 2 (the underwriting gain of 8 minus the protection against loss deduction of 6—of which 4 represents the amount determined under sec. 824(a)(1)(A) and 2 represents the amount determined under sec. 824(a)(1)(B)—or 8 minus 6). Accordingly, R's mutual insurance company taxable income for 1963 would be 12. This amount consists of the taxable investment income of 10 (gross investment income minus deductions under sec. 822(c), or 50 minus 40) plus the statutory underwriting income of 2. Since all of R's mutual insurance company taxable income of 12 is attributable to the limitation under section 826(b), the entire amount is subject to the surtax under section 821(a)(2) without regard to the $25,000 surtax exemption. The credit of 16, representing that part of the taxes paid by A which is allocable to the income received by A from R, may be applied by R against its taxes with respect to its mutual insurance company taxable income of 12 for 1963, and R would be entitled to a refund of any excess of the amount of such credit over its tax liability for 1963.

Under the provisions of section 826(d), no portion of the amount added to such account in 1963 by reason of the election under section 826(a), 2 (25 percent of the amount by which the consolidated underwriting gain exceeds 25 percent of the underwriting gain determined without regard to the election under sec. 826(a), or the amount by which 25 percent of 8 exceeds 25 percent of 0), may be permitted to continue to remain in the protection against loss accounts beyond the taxable year 1968.

(d) *Exemption from tax.*—The bill as reported by your committee adds an amendment to section 501(c)(15) (relating to exemption from tax of certain mutual insurance companies) by striking out "$75,000" and inserting in lieu thereof "$150,000". Thus, the $75,000 exemption

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for certain mutual insurance companies under existing law is increased to $150,000, in accordance with the changes made in section 821 by your committee.

SECTION 8. MUTUAL INSURANCE COMPANIES (OTHER THAN LIFE, MARINE, AND CERTAIN FIRE OR FLOOD INSURANCE COMPANIES), ETC. (Continued)

(e) *Mutual fire insurance companies operating on basis of premium deposits.*—Subsection (e) of section 8 of the bill, which corresponds to subsection (d) of section 10 of the bill as passed by the House, amends section 831(a) of the 1954 Code to include mutual fire insurance companies operating on the basis of premium deposits among the companies which are subject to the tax imposed by part III of subchapter L of chapter 1 of the code. Your committee's amendment adds mutual flood insurance companies to this group.

(*1*) *Application of section 831(a).*—Subsection (e)(1) of section 8 of the bill amends section 831(a) of the code (which imposes a tax on certain mutual marine and mutual fire insurance companies and on stock insurance companies which are not life insurance companies) to provide that, for taxable years beginning after December 31, 1962, mutual fire or flood insurance companies operating on the basis of premium deposits are to be subject to tax under part III of subchapter L. Under existing law, mutual fire insurance companies operating on the basis of premium deposits (the so-called factory mutual insurance companies) are taxed in the same manner as any other mutual insurance company (other than a life or marine or fire insurance company issuing perpetual policies); thus, these companies are subject to the tax imposed by section 821. (See *Philadelphia Manufacturers Mutual Insurance Company* v. *Commissioner* (1959), 33 T.C. 490, aff'd (C.A. 3d 1960) 284 F. 2d 296.) Under the bill, every mutual fire or flood insurance company whose principal business is the issuance of policies for which the premium deposits are the same, regardless of the length of the term for which the policies are written, will be subject to the tax imposed by section 831(a) if the unabsorbed portion of such premium deposits not required for losses, expenses, or establishment of reserves is returned or credited to the policyholder on cancellation or expiration of the policy. For purposes of this subsection, in the case of a mutual flood insurance company, the premium deposits will be considered to be the same if the payment of a premium increases the total insurance under the policy in an amount equal to the amount of such premium, and the omission of any annual premium does not result in the reduction or suspension of coverage under the policy.

(*2*) *Treatment of unabsorbed premium deposits.*—Subsection (e)(2) of section 8 of the bill amends section 832(b)(4) of the code (relating to definition of premiums earned) to provide that for purposes of determining the premiums earned on insurance contracts during the taxable year in the case of a mutual fire or flood insurance company operating on the basis of premium deposits, the term "unearned premiums" means (with respect to the policies described in sec. 831(a)(3)(B)) the amount of unabsorbed premium deposits which the company would be obligated to return to its policyholders at the close of the company's taxable year if all of such policies were terminated at such

time. This paragraph further provides that for purposes of determining the amount which such company would be obligated to return to its policyholders at the close of any taxable year, the company must use its own schedule of unabsorbed premium deposit returns then in effect.

(*3*) *Conforming amendments.*—Subparagraph (e)(3) of section 8 of the bill amends section 832(b)(1)(C) of the code (relating to definition of gross income) to conform to the amendment to section 831(a).

(*4*) *Adjustment of premium deposit.*—Subparagraph (e)(4) of section 8 of the bill amends section 832(c)(11) of the code (relating to deduction for dividends to policyholders) to provide that the term "dividends and similar distributions" includes amounts returned or credited to policyholders on cancellation or expiration of factory mutual policies described in the new section 831(a)(3)(B).

(*5*) *Additional item of income.*—Subparagraph (e)(5) of section 8 of the bill amends section 832(b)(1) of the code (relating to the definition of gross income) to provide that, in the case of a mutual fire or flood insurance company operating on the basis of premium deposits, gross income includes an amount which is equal to 2 percent of premiums earned on insurance contracts during the taxable year with respect to policies described in section 831(a)(3)(B) after deduction of premium deposits returned or credited during the same taxable year. The term "premiums earned on insurance contracts during the taxable year", for purposes of this section, means thea bsorbed premiums for the taxable year determined in accordance with the schedule of unabsorbed premium deposits in effect at the end of the taxable year.

(f) *Election of certain mutual companies to be taxed on total income.*—Subsection (f) of section 8 of the bill, which corresponds to subsection (e) of section 10 of the bill as passed by the House, amends section 831 of the code (relating to tax on insurance companies (other than life or mutual), mutual marine insurance companies, and mutual fire insurance companies issuing perpetual policies) by redesignating subsection (c) as subsection (d) and adding a new subsection (c). The new section 831(c) provides that any mutual insurance company engaged in writing marine, fire, and casualty insurance which for any 5-year period beginning after December 31, 1941, and ending before January 1, 1962, was subject to the tax imposed by section 831 (or the tax imposed by corresponding provisions of prior law) may elect to be subject to the tax imposed by section 831, whether or not marine insurance is its predominant source of premium income. If such election is made, the electing company shall be subject to the tax imposed by section 831, for years beginning after December 31, 1961, rather than subject to the tax imposed by section 821. Such election shall not be revoked except with the consent of the Secretary of the Treasury or his delegate.

(g) *Technical amendments, etc.*—This subsection, which corresponds to subsection (f) of the bill as passed by the House, makes certain technical changes to provisions of the 1954 Code outside of parts II or III of subchapter L to conform those provisions to the changes in subchapter L made by section 8 of the bill.

(*1*) *Credit for foreign taxes.*—Subsection (g)(1) amends section 841 of the code (providing for the allowance to an insurance company of the foreign tax credit provided in sec. 901) so as to define the term "taxable income," as used in section 904, to mean the mutual insurance company taxable income (as defined in sec. 821(b)) in the case of the

tax imposed by section 821(a), and the taxable investment income (as defined in sec. 822(a)(1)) in the case of the tax imposed by section 821(c).

(2) *Adjustments to basis for depreciation sustained.*—Subsection (g)(2) amends section 1016(a)(3) of the code (relating to adjustments to basis for depreciation, etc., sustained) to provide, in effect, that any exhaustion, wear and tear, obsolescence, amortization, and depreciation, to the extent sustained (and to the extent sec. 1016(a)(2) does not apply), on property held in respect of any period since February 28, 1913, by a person subject to tax under part II of subchapter L (or the corresponding provisions of prior income tax laws), must be taken into account in determining the adjusted basis of such property.

(3) *Alternative tax on capital gains.*—Subsection (g)(3) amends section 1201(a) of the code (relating to alternative tax on capital gains) to conform to the amendment to section 821.

(4) *Clerical amendments.*—Subsection (g)(4) makes clerical conforming changes.

(h) *Effective date.*—Subsection (h) of section 8 of the bill provides that the amendments made by section 8 of the bill (other than by subsec. (f)) shall apply only with respect to taxable years beginning after December 31, 1962. Section 831(c) of the code, as added by subsection (f) of section 8, is applicable for taxable years beginning after December 31, 1961.

SECTION 9. DOMESTIC CORPORATIONS RECEIVING DIVIDENDS FROM FOREIGN CORPORATIONS

Section 9 of the bill, corresponding to section 11 of the bill as passed by the House, deals with the method to be used for determining the amount of foreign income tax deemed to have been paid by domestic corporations with respect to dividends received from foreign corporations for purposes of allowance of a foreign tax credit under section 902 of the code. Section 9 of the bill revises section 902 of the code, and requires (under a new sec. 78) the inclusion of certain taxes deemed paid in income as a dividend from corporations other than certain less developed country corporations (the bill as passed by the House applied such rule to dividends from all foreign corporations). The new section 902 omits the present subsection (d), which provides a special rule for allowance of a foreign tax credit with respect to royalty or compensation payments made by certain wholly owned foreign subsidiaries to domestic parents in lieu of dividends. Section 9 also changes the source of income rule of section 861(a)(2)(B) with respect to dividend income received from a foreign corporation which derived income from sources within the United States and for which a dividends received deduction was allowed under section 245.

(a) *Entire amount of foreign tax to be taken into account.*—Subsection (a) of the new section 9 revises section 902. Paragraph (1) of subsections (a) and (b) of section 902 as revised, and subparagraph (A) of subsection (c)(1), provide a new formula for determining the amount of foreign income tax deemed to have been paid by a domestic corporation with respect to dividends received from a foreign corporation other than a less developed country corporation. Paragraph (2) of subsections (a) and (b), and subparagraph (B) of subsection (c)(1),

of section 902 as revised continue existing law for determining the amount of foreign income tax deemed to have been paid by a domestic corporation with respect to dividends from less developed country corporations. Subsections (b)(1) and (c)(1)(A) apply only if subsection (a)(1) applies, and subsections (b)(2) and (c)(1)(B) apply only if subsection (a)(2) applies. The first clause of section 902(c)(1) of existing law defines accumulated profits as gains, profits, or income reduced by the amount of taxes with respect thereto. Under subsection (c)(1)(A) of section 902 as revised, however, accumulated profits are defined as gains, profits, or income computed without reduction by the amount of the income, war profits, and excess profits taxes imposed by a foreign country or possession of the United States on or with respect to such profits or income. Taxes imposed by the United States will, however, continue to reduce such accumulated profits.

The redefinition of accumulated profits increases the amount of taxes to be taken into account in applying the proportions provided in section 902 (a)(1) and (b)(1) of the code. Under existing law, a credit is allowed to a domestic corporation for all or a part of the foreign taxes paid on or with respect to the accumulated profits of the foreign corporation making a distribution. However, by the existing definition, accumulated profits are total profits less taxes thereon. The Supreme Court, in *American Chicle Co.* v. *United States*, 316 U.S. 450 (1942), has held that the amount of tax paid on or with respect to a foreign corporation's accumulated profits is the same proportion of total taxes on profits as accumulated profits is of total profits. Thus, if a corporation had total profits of $100, foreign taxes of $40, and therefore accumulated profits of $60, the amount of taxes paid on or with respect to accumulated profits would be $24 ($40×$60/100). If the accumulated profits of $60 were paid as a dividend, no more than $24 could be allowed as a credit as deemed paid under section 902 of existing law.

As amended, the section 902(c)(1)(A) definition will permit the taking into account of a stated proportion of total taxes under section 902(a)(1) and 902(b)(1). For such purpose it is no longer necessary to apply the *American Chicle* rule. Since accumulated profits would be total profits without reduction for taxes paid thereon, the amount of taxes paid on or with respect to accumulated profits would, in the above example, be $40 rather than $24.

Subsections (a)(1) and (b)(1) of section 902 as revised provide for the use of the proportion which distributed dividends bear to the accumulated profits in excess of foreign taxes. The result is to continue under such subsections the use of the ratios under existing law, but because of section 902(c)(1)(A) the amount against which the ratios operate is increased.

The application of these changes in a section 902(a)(1) computation may be illustrated by the following example involving corporation P, a domestic corporation which owns 100 percent of the voting stock of corporation FC, a foreign corporation not a less developed country corporation. It is assumed that all transactions have taken place within, and are related to, the same taxable year.

Example 1

(i)	Gains, profits, and income of corporation FC	$100
(ii)	Foreign tax paid by corporation FC with respect to such gains, profits, and income	30
(iii)	Accumulated profits of corporation FC computed without reduction for foreign taxes (sec. 902(c))	100
(iv)	Accumulated profits of corporation FC reduced by foreign taxes (sec. 902(a))	70
(v)	Dividends paid by corporation FC to corporation P	35
(vi)	Corporation P is deemed to have paid the same proportion of the total tax paid by corporation FC as dividends, determined without regard to section 78, bear to accumulated profits in excess of taxes: $30× 35/70	15

Example 1 will apply to all dividends received by a domestic corporation after December 31, 1964, from a foreign corporation (not a less developed country corporation), regardless of the year in which the profits from which such dividends were paid were accumulated. Example 1 will also apply with respect to dividends received by a domestic corporation from such a foreign corporation in its taxable years beginning after December 31, 1962, so long as the dividends from the foreign corporation are attributable to accumulated profits of the foreign corporation for its taxable years beginning after December 31, 1962. However, for periods before January 1, 1965, the *American Chicle* rule and the present section 902(a) treatment will continue to apply where the dividends from such a foreign corporation are attributable to accumulated profits for taxable years beginning before January 1, 1963. Following the established rule, a foreign corporation is considered to be making a distribution first from its accumulated profits for its current taxable year and then from its accumulated profits of its immediately preceding year, etc.

The following example illustrates the above rules where a dividend is distributed out of both accumulated profits for taxable years beginning after December 31, 1962, and accumulated profits for taxable years beginning before January 1, 1963. The facts are the same as in example 1 except for the noted differences:

Example 2

(i)	Gains, profits, and income of corporation FC in 1963		$100
(ii)	Foreign tax paid by corporation FC with respect thereto		40
(iii)	1962 accumulated profits and foreign tax:		
	Accumulated profits (existing sec. 902(c))		60
	Foreign tax		40
(iv)	Dividends paid by corporation FC to corporation P in 1963 and the year to which such dividends are attributable:		
	1963	$60	
	1962	30	
			90
(v)	Corporation P is deemed to have paid a foreign tax with respect to the 1963 accumulated profits of corporation FC computed in the same manner as in example 1 ($40×60/60)		40
(vi)	Corporation P is deemed to have paid a foreign tax with respect to the 1962 accumulated profits of corporation FC in the same manner as existing rules ($40×60/100×30/60)		12
(vii)	Total foreign tax corporation P is deemed to have paid ((v)+(vi))		52

The new subsections (a)(1), (b)(1), and (c)(1)(A), when applied to dividends received after December 31, 1964, will not be affected by the fact that there may have been in an earlier year a partial distribution of accumulated profits to which the *Chicle* rule applied. For example, if a wholly owned foreign subsidiary (not a less developed country corporation) of a domestic corporation had total profits of $100, upon which foreign taxes of $40 had been paid, accumulated

profits under existing law would be $60. Under the *Chicle* rule the taxes paid with respect to the accumulated profits would be $24 ($40×$60/100). Upon a distribution of one-half ($30) of such accumulated profits the domestic parent would be entitled under existing section 902(a) to a maximum credit of $12. However, if at any time after 1964, the subsidiary distributes another dividend, $30, with respect to the accumulated profits of such earlier year, and taxes deemed paid, determined in accordance with new section 902(a)(1), will be the same proportion of total taxes as the dividend bears to accumulated profits in excess of foreign taxes. Thus, the total tax of $40 would be multiplied by the fraction 30/60 and the parent would be entitled under section 902(a), as amended, to a credit of $20. No account is to be taken of the foreign tax of $8 which, because of the *Chicle* rule, was not taken into account in the earlier dividend year.

If a dividend from a foreign corporation (not a less developed country corporation) is distributed out of its accumulated profits for a taxable year beginning after 1962, and such accumulated profits are composed in whole or in part of dividends which were received from accumulated profits of a foreign subsidiary of the foreign corporation accumulated in taxable years beginning after 1962, both subsections (a)(1) and (b)(1) applies. After 1964 the new subsections (a)(1) and (b)(1) of section 902 will apply whether the distributions are from accumulated profits of the foreign corporation and its foreign subsidiary for their taxable years beginning after 1962 or before 1963. The computation involving these rules may be illustrated by the following example involving corporation P, a domestic corporation which owns 100 percent of the voting stock of foreign corporation FC (not a less developed country corporation) which in turn owns 100 percent of the voting stock of foreign subsidiary FS. It is assumed that all transactions have taken place and are related to the taxable year 1963.

Example 3

(A) Application of section 902(b)(1) to determine tax deemed to be paid by corporation FS:

(i)	Gains, profits, and income of corporation FS	$100
(ii)	Foreign tax paid by corporation FS with respect to such gains, profits, and income	20
(iii)	Accumulated profits in excess of taxes of corporation FS: $100 less $20	80
(iv)	Dividends paid by corporation FS to corporation FC	40
(v)	Corporation FS foreign tax which is deemed paid by corporation FC: $20×40/80	10

(B) Application of amended section 902(a)(1) to determine tax deemed to be paid by corporation P:

(i)	Gains, profits, and income of corporation FC:	
	Business profits	$100
	Dividends from corporation FS	40
		140
(ii)	Foreign tax paid by corporation FC with respect to its gains, profits, and income	40
(iii)	Accumulated profits in excess of taxes paid by corporation FC: $140 less $40	100
(iv)	Dividend paid by corporation FC to corporation P	80
(v)	Foreign tax paid ($40) and deemed paid ($10) by corporation FC	50
(vi)	Foreign taxes paid and deemed paid by corporation FC which are deemed paid by corporation P: $50×80/100	40

Where a dividend from a foreign corporation (not a less developed country corporation) before 1965 is attributable to its accumulated profits for a taxable year beginning after 1962, but which profits are composed in part of a dividend received by such foreign corporation from the accumulated profits of its foreign subsidiary for a taxable year or years of the subsidiary beginning before 1963, for purposes of computing the foreign tax credit a pro rata amount of the dividend received from the foreign corporation will be deemed to consist of accumulated profits of its foreign subsidiary attributable to the period before 1963. Existing law will apply to that portion of the foreign tax paid or accrued or deemed paid by the foreign corporation with respect to such pro rata amount of the dividend considered attributable to the accumulated profits of its subsidiary for taxable years before 1963 and the amendment made by section 9 of the bill will apply to the balance of such tax.

The new subsections (a)(1), (b)(1), and (c)(1)(A) apply to the extent that a domestic corporation receives dividends from the accumulated profits of a foreign corporation for a taxable year for which it is not a less developed country corporation, and shall apply although such accumulated profits include dividends from accumulated profits of another foreign corporation for a taxable year for which such other foreign corporation is a less developed country corporation. Such provisions do not apply if the dividend is from accumulated profits of a corporation for a taxable year for which it is a less developed country corporation even though such accumulated profits includes dividends from accumulated profits of another foreign corporation for a taxable year for which such other corporation is not a less developed country corporation.

The new subsection (d) of section 902 as revised defines a less developed country corporation for the purpose of section 902 as a foreign corporation—

(1) which, for its taxable year, is a less developed country corporation under section 955(c) (1) or (2), or

(2) which owns at least 10 percent of all classes of stock entitled to vote of a less developed country corporation under section 955(c)(1), derives at least 80 percent of its gross income for its taxable year from sources within less developed countries under section 955(c)(1)(A), and at least 80 percent in value of its assets on each day of such year consists of property described in section 955(c)(1)(B).

A foreign corporation which is a less developed country corporation for its first taxable year beginning after December 31, 1962, is to be treated as such for each of its prior taxable years. Thus, if, after December 31, 1964, a domestic corporation receives a dividend from a foreign corporation from its accumulated profits for a taxable year beginning before December 31, 1962, the rules of existing law apply if such foreign corporation is a less developed country corporation for its first taxable year beginning after December 31, 1962, without regard to its earlier status.

(b) *Inclusion in gross income of amount equal to taxes deemed paid.*—Subsection (b) of section 9 of the bill amends part II of subchapter B of chapter 1 (relating to items specifically included in income) by adding at the end thereof a new section 78. Section 78 requires a domestic corporation to include in gross income as a dividend an amount equal

to the taxes deemed, as a result of section 902 (a)(1), (b)(1), and (c)(1)(A) of the code, as added by subsection (a) of section 9 of the bill, or as a result of section 960(a)(1)(C) (relating to taxes paid by foreign corporation), as added by section 12 of the bill, to have been paid by the domestic corporation, if the domestic corporation chooses the benefits of the foreign tax credit. Section 78 does not apply where the taxes attributable to a particular distribution are computed under present law. Thus, in the preceding example 1 corporation P will include $15 in gross income as a dividend. In example 2 corporation P will include only $40 in gross income since $12 of foreign tax deemed to be paid by corporation P is computed under existing rules. In example 3 corporation P will include $40 in gross income.

The amount included in gross income by operation of section 78 is treated as a dividend in the same manner as a dividend actually received by the domestic corporation from a foreign corporation. For example, a section 78 dividend is included in gross income under section 61(a)(7); is personal holding company income for purposes of section 543(a)(1); and may be a portion of accumulated taxable income for purposes of section 535. However, a section 78 dividend is not a dividend for purposes of section 245 of the code (relating to deduction for dividends received from certain foreign corporations).

(c) *Determination of source of dividends received from certain foreign corporations.*—Subsection (c) of section 9 of the bill amends section 861(a)(2)(B) of the code by striking out "to the extent exceeding the amount of the deduction allowable under section 245 in respect of such dividends" and inserting in lieu thereof "to the extent exceeding the amount which is 100/85ths of the amount of the deduction allowable under section 245 in respect of such dividends." This restores the rule contained in section 119(a)(2)(B) of the 1939 Code, as added by the Revenue Act of 1951. The effect of the change is to establish a closer correlation between the operation of sections 245 and 861(a)(2)(B) than existing law provides.

Under present section 861(a)(2)(B), the excess of the amount of a dividend taken into account in determining the dividends received deduction under section 245 over the amount allowed as a deduction, is determined to be income from sources without the United States for purposes of the foreign tax credit provisions. As a result, 15 percent of that portion of the dividend considered as derived from sources within the United States within the meaning of section 245 is treated as income from sources within the United States for purposes of that section, but, conversely, is treated as income from sources without the United States under section 861(a)(2)(B) for foreign tax credit purposes. Subsection (c) removes this inconsistency by treating as income from sources without the United States for foreign tax credit purposes only the amount of the dividend in excess of one hundred eighty-fifths of the dividends received deduction.

(d) *Technical amendments.*—Subsection (d) of section 9 of the bill conforms the table of sections for part II of subchapter B of chapter 1 of the code to the addition of the new section 78 and adds a cross-reference to section 901 of the code. In addition it makes technical changes in section 535(b)(1) and 545(b)(1) to prevent the amendments made by section 9 of the bill from changing "accumulated taxable income" for purposes of the accumulated earnings tax and "undistributed personal holding company income" for purposes of the

personal holding company tax and to offset the effects of section 78 whereby these incomes are increased by reason of the taxes deemed to have been paid under section 902 (a)(1), (b)(1), and (c)(1)(A). These technical changes will allow as a deduction the taxes deemed to have been paid under section 902 (a)(1), (b)(1), and (c)(1)(A).

(e) *Effective date.*—Subsection (e) of section 9 of the bill provides that the amendments made by section 9 are to be applicable to dividends which are received by domestic corporate taxpayers in their taxable years beginning after December 31, 1962, but only to the extent that such distributions are made out of the accumulated profits of foreign corporations for their taxable years beginning after December 31, 1962. However, the amendments made by section 9 of the bill will be applicable to all dividends received by domestic corporate taxpayers from foreign corporations after December 31, 1964, regardless of the year to which the accumulated profits are attributable.

If, before 1965, the distribution from a foreign corporation for its taxable year beginning after December 31, 1962, is out of profits which are attributable to a distribution received by such foreign corporation from its foreign subsidiary, the effectiveness of the amendments depends on the taxable year to which the subsidiary's distribution is attributable. If the distribution is out of the subsidiary's accumulated profits for taxable years beginning after December 31, 1962, the amendments will be applicable. However, if the distribution is attributable to the subsidiary's accumulated profits for taxable years beginning before January 1, 1963, the present law will continue in effect.

The amendments are not applicable to a domestic corporation receiving a distribution from a foreign corporation prior to January 1, 1965, unless such distribution (1) is made out of profits of a foreign corporation accumulated in a taxable year beginning after December 31, 1962, and (2) is received by the domestic corporation in a taxable year beginning after December 31, 1962. Therefore, if for example, a foreign corporation is on a calendar-year basis and it makes a distribution on November 15, 1963, out of its accumulated profits for 1963 to a domestic corporation whose taxable year began on December 1, 1962, the present law would be applicable.

SECTION 10. SEPARATE LIMITATION ON FOREIGN TAX CREDIT WITH RESPECT TO CERTAIN INTEREST INCOME

Section 10 of the bill, for which there is no corresponding provision in the bill as passed by the House, amends section 904 (relating to limitations on the foreign tax credit) by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) a new subsection (f) relating to special rules in case of certain interest income.

Existing law

Under section 904(a) of existing law a taxpayer may elect between two alternative limitations on the amount of the foreign tax credit:

(1) The per country limitation limits the credit for tax paid or accrued to any one foreign country (or U.S. possession) to the proportion of U.S. tax before credit which taxable income from sources within such country (or possession) bears to the entire taxable income;

(2) The overall limitation limits the total credit for taxes paid or accrued to all foreign countries or U.S. possessions to the proportion of U.S. tax before credit which taxable income from all sources without the United States bears to the entire taxable income.

Separate limitation for interest income.—Paragraph (1) of new subsection (f) requires a taxpayer to apply subsection (a) of section 904 (and the related rules of subsecs. (c), (d), and (e)) with respect to interest described in paragraph (2) separately from all other income.

Paragraph (2) defines the interest income to which paragraph (1) applies as taxable income from interest other than interest—

(A) derived from transactions directly related to the active conduct of a trade or business in a foreign country or U.S. possession,

(B) derived in the conduct of a banking, financing, or similar business, or

(C) received from a corporation in which the taxpayer owns at least 10 percent of the voting stock.

Paragraph (3) provides that the overall limitation does not apply to interest described in paragraph (2) and that the Secretary of the Treasury or his delegate shall by regulations prescribe the manner of application of the foreign tax credit carrybacks and carryovers where the taxpayer elects the overall limitation as to other income.

Paragraph (4) provides transitional rules for foreign tax credit carrybacks and carryovers. Under subparagraph (A), carrybacks of taxes paid or accrued in taxable years beginning after the date of enactment of the bill carried to taxable years beginning on or before such date are determined without regard to new subsection (f). Where such taxes are carried back to taxable years beginning on or before such date of enactment and are partially deemed paid or accrued in such taxable years, the excess, if any, when carried forward is deemed paid or accrued in a taxable year beginning after the date of enactment, with respect to—

(i) interest (described in par. (2)) in the ratio that taxes paid or accrued with respect to such interest to a foreign country or possession in the year in which the tax was actually paid or accrued (in excess of the applicable limitation for such year) bears to the total tax paid or accrued to such country or possession in such year (in excess of the applicable limitation for such year); and

(ii) other income in the ratio that taxes paid or accrued with respect to such other income to a foreign country or possession in the year in which the tax was actually paid or accrued (in excess of the applicable limitation for such year) bears to the total taxes paid or accrued to such country or possession for such year (in excess of the applicable limitation for such year).

Under subparagraph (B) taxes, paid or accrued in a taxable year beginning on or before the date of enactment, are when carried forward deemed paid or accrued in a taxable year beginning after such date with respect to—

(i) interest (described in par. (2)) in the ratio that taxes paid or accrued to a foreign country or possession in the later year with respect to such interest bears to the total taxes paid or accrued in such year to such country or possession; and

(ii) other income in the ratio that taxes paid or accrued to a foreign country or possession in the later year with respect to such other income bears to the total taxes paid or accrued in such year to such country or possession.

If the taxpayer uses the overall limitation provided in section 902 (a)(2) with respect to income other than the interest income to which paragraph (2) applies, the computation under subparagraphs (A) and (B) of paragraph (4) will, under the provisions of paragraph (3), be computed, with respect to such other income, on the basis of the overall limitation.

Example 1.—Corporation M, to which the per country limitation applies, has for the taxable year 1963 \$50,000 of taxable income described in paragraph (2) from sources within country X, \$100,000 of other taxable income from sources within that country, and \$150,000 of taxable income (none of which is interest income) from sources within country Y. M has no other income (or losses) from sources without the United States in 1963 and has total taxable income from all sources (including countries X and Y) of \$2 million. It pays or accrues income tax for 1963 to country X of \$15,000 with respect to income described in paragraph (2), and \$60,000 with respect to other income, and it pays or accrues \$75,000 income tax to country Y. M's U.S. tax (before credit) is \$1,040,000. M's country X foreign tax credit limitation with respect to interest described in paragraph (2), is $\$1{,}040{,}000 \times \frac{\$50{,}000}{\$2{,}000{,}000}$, or \$26,000, so that the full amount of the \$15,000 of country X tax is allowed as a credit for 1963. M's country X limitation on credit for taxes with respect to other income is $\$1{,}040{,}000 \times \frac{\$100{,}000}{\$2{,}000{,}000}$, or \$52,000 so that \$52,000 of the \$60,000 of country X tax with respect to such other income is allowed as a credit for 1963. M's country Y limitation, $\$1{,}040{,}000 \times \frac{\$150{,}000}{\$2{,}000{,}000}$, or \$78,000, is unaffected by the new subsection (f) since M has no taxable income described in paragraph (2) from sources within country Y. M's total foreign tax credit is therefore \$142,000 (\$15,000+\$52,000+\$75,000).

Example 2.—Assume the same facts as in example 1 except that M has elected the overall limitation. The limitation on the credit for foreign tax paid or accrued to country X with respect to the income described in paragraph (2) is $\$1{,}040{,}000 \times \frac{\$50{,}000}{\$2{,}000{,}000}$, or \$26,000, the same as in example 1, and would not change even if M also had taxable income described in paragraph (2) from sources within some other foreign country, since the overall limitation is unavailable with respect to income described in paragraph (2). M's overall limitation with respect to foreign tax on all other income is $\$1{,}040{,}000 \times \frac{\$100{,}000+\$150{,}000}{\$2{,}000{,}000}$, or \$130,000, so that of the \$135,000 (\$60,000 +\$75,000) foreign taxes paid or accrued with respect to income other than income described in paragraph (2), \$130,000 is allowed as a credit. M's total credit is therefore \$145,000 (\$130,000+\$15,000).

Example 3.—Corporation O, which does not elect the overall limitation, paid or accrued to country X for the taxable year 1962

$100 of foreign tax in excess of the section 904 limitation. Corporation O has no income from sources within any other country. For 1963, O pays or accrues to country X $20 in tax on income described in paragraph (2) and $80 in tax on other income. The section 904 limitation for 1963 is $50 with respect to income described in paragraph (2) and $80 with respect to other income. With respect to the $100 carryover from 1962, corporation O is deemed to have paid or accrued in 1963 $20, i.e., $\frac{\$20}{\$100}\times\$100$. The remaining $80 of the carryover may be carried to 1964, and assuming the same amount of taxes are paid or accrued in 1964 as in 1963 and the same limitations are applicable, O is deemed to have paid or accrued in 1964 $16, i.e., $\frac{\$20}{\$100}\times\$80$.

Example 4.—Assume the same facts as in example 3 except that the limitation under section 904 for 1962 exceeds the tax paid or accrued for that year by $10, and the limitation for 1964 with respect to income other than that described in paragraph (2) is $50. Under these facts, the excess of the $80 tax paid or accrued for 1964 with respect to other income over the limitation of $50, or $30, is carried back first to 1962, and $10 will be deemed paid or accrued for that year. The remaining $20 is carried to 1963, but no amount will be deemed paid or accrued in 1963 since the tax being carried back was paid or accrued with respect to income other than that described in paragraph (2) and the limitation for 1963 with respect to such income does not exceed the tax actually paid or accrued for such year with respect to such income.

Example 5.—Assume the same facts as in example 4 except that the limitation for 1964 with respect to income described in paragraph (2) is $10. The excess of the $20 tax paid or accrued for 1964 with respect to income described in paragraph (2) over the limitation of $10, or $10, is aggregated with the excess tax of $30 paid in 1964 with respect to other income, making a total of $40. Of this aggregate amount, $10 will be deemed paid or accrued in 1962 as in example 4. Of the remaining $30, $7.50 $\left(\frac{\$10}{\$40}\times\$30\right)$ will be deemed paid or accrued in 1963 with respect to interest income described in paragraph (2). No amount will be deemed paid or accrued in 1963 with respect to other income because the limitation for that year with respect to other income ($80) does not exceed the tax actually paid or accrued for that year with respect to such other income ($80).

Effective date.—The new subsection applies with respect to taxable years beginning after the date of enactment of the bill but only with respect to interest resulting from transactions consummated after April 2, 1962.

SECTION 11. EARNED INCOME FROM SOURCES WITHOUT THE UNITED STATES

This section is the same as section 12 of the bill as passed by the House except for the addition of a presumption in certain circumstances with respect to bona fide residence and a temporary exemption for certain noncash remuneration.

(a) *Limitation on amount and type of income excluded.*—Subsection (a) of section 11 of the bill amends section 911 of the 1954 Code. This amendment retains the provisions of section 911 which require, under certain circumstances, the exclusion of earned income from gross income of an individual who has been a bona fide resident, or is physically present, in a foreign country. However, under the amendment there will be dollar limitations on the amounts which may be excluded under section 911 by any individual. The amendment also imposes a requirement as to time of receipt and, for some purposes, attributes amounts received to the taxable year in which the services to which the amounts are attributable were performed. The amendment also provides that no amount received as a pension or annuity is excludable under section 911. Your committee has added amendments which provide a presumption in certain circumstances with respect to bona fide residence and a temporary exemption for certain noncash remuneration.

SECTION 911. EARNED INCOME FROM SOURCES WITHOUT THE UNITED STATES

(a) *General rule.*—Subsection (a) of section 911, as amended by section 11 of the bill, is the same as existing law in that it provides that in the case of an individual citizen of the United States—

(1) who has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, or

(2) who during any period of 18 consecutive months is present in a foreign country or countries during at least 510 full days in such period,

amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) which constitute earned income attributable to services performed during the uninterrupted period or during an 18-month period, whichever applies, may be excluded from gross income. However, the amended section 911(a) contains a new provision to the effect that the amount excluded under that provision will be computed by applying special rules contained in subsection (c). The new provision referring to the special rules in subsection (c) is in lieu of the unlimited exclusion provided by existing law with respect to bona fide foreign residence, and the $20,000 limitation with respect to physical presence in a foreign country provided by existing law. Subsection (a) also retains the provision of existing law that no deductions (other than the deductions allowed by sec. 151, relating to personal exemptions) will be allowed to the extent such deductions are properly allocable to or chargeable against amounts excluded from gross income under such subsection.

(b) *Definition of earned income.*—Subsection (b) of the amended section 911 continues, without change, the existing definition of "earned income."

(c) *Special rules.*—Subsection (c) of section 911, as amended by the bill, provides rules for purposes of computing the amount excludable from gross income of an individual under section 911(a).

Paragraph (1) of section 911(c) contains the limitations on the amount excludable under section 911(a). It provides, as a general rule, that the amount excluded for any taxable year is not to exceed

an amount which is to be computed on a daily basis at an annual rate of $20,000. However, the annual rate is to be $35,000 in the case of an individual who qualifies as a bona fide resident of a foreign country or countries under section 911(a)(1), but only with respect to taxable years (or a portion of a taxable year) occurring immediately after such individual has been a bona fide foreign resident for any uninterrupted period of 3 consecutive years (36 consecutive months). The amount excludable accrues on a daily basis throughout the taxable year. The number of days to be used in making the computation on a daily basis is the number of days in the taxable year for which the exclusion is claimed.

The manner of computing the amount excludable under section 911(a) on a daily basis at the prescribed annual rates may be illustrated by the following example:

Example.—A, a U.S. citizen, who files his returns on a calendar year basis, is privately employed, and is a bona fide resident of France for the period April 1, 1963, through June 30, 1968. The amounts excludable from his gross income for the various calendar years under the provisions of section 911(a) which are computed by applying the special rules contained in section 911(c) are not to exceed the following amounts: For the year 1963, $15,068.49 (275/365×$20,000); for the year 1964, $20,000 (366/366×$20,000); for the year 1965, $20,000 (365/365×$20,000); for the year 1966, $31,301.37 (90/365×$20,000 plus 275/365×$35,000); for the year 1967, $35,000; and, for the year 1968, $17,404.37 (182/366×$35,000).

An individual who, on January 1, 1963, has been a bona fide foreign resident for an uninterrupted period in excess of 3 consecutive years is immediately entitled to the benefits of the annual rate of $35,000. An individual who returns and takes up residence in the United States is, upon resuming bona fide foreign residence, only entitled to the benefits of the annual rate of $20,000 until such individual completes another uninterrupted period of 3 consecutive years of bona fide foreign residence.

Paragraph (2) of section 911(c) provides that, for purposes of applying the limitation in paragraph (1), amounts received are to be considered received in the taxable year in which the services to which the amounts are attributable are performed. For example, amounts received during the taxable year 1965 attributable to services performed during the taxable year 1964 will, for purposes of applying the limitation in section 911(c)(1), be considered received in the taxable year 1964. Thus, if I (to whom the $20,000 limitation applies) receives $16,000 in 1964 and $7,000 in 1965, both amounts being attributable to his 1964 services, $3,000 of the $7,000 received in 1965 would be includible in his gross income for 1965.

Paragraph (3) of section 911(c) provides in effect that in applying the rules of paragraph (1), the amount excludable under section 911(a) is to be neither increased nor decreased solely by operation of community property law.

The application of the rule contained in section 911(c)(3) may be illustrated by the following examples:

Example 1.—H, a U.S. citizen, qualifies under section 911(a) and receives $40,000 during a taxable year for services performed abroad during such taxable year. He has been abroad for less than 3 consecutive years. W, the wife of H, earns no income of her

own and continues to live in a community property State in the United States. The marital domicile also continues in such State. H and W file a joint return. The aggregate amount excludable from gross income under section 911 is $20,000. If H and W had filed separate returns, the aggregate amount excludable under section 911 would be $20,000.

Example 2.—The facts are the same as in example 1, except that W also resides abroad. Whether H and W file their returns separately or jointly, the aggregate amount excludable under section 911 is $20,000. If W also qualifies under section 911(a) and receives $10,000 during the taxable year for services she performed abroad during such taxable year, the aggregate amount excludable under section 911 is $30,000 (whether a joint return or separate returns are filed).

Similarly, in a noncommunity property jurisdiction, if H and W both qualify under section 911(a) and receive $40,000 and $10,000, respectively, for services performed abroad during the taxable year, the aggregate amount excludable under section 911 is $30,000.

Paragraph (4) of section 911(c) establishes a requirement as to time of receipt by providing that no amount received after the close of the taxable year following the taxable year in which the services to which the amounts are attributable are performed may be excluded under section 911(a). For example, an amount received on or before the close of the taxable year 1965 which is attributable to services performed during the taxable year 1964 will satisfy the requirement as to receipt of section 911(c)(4). However, an amount received after the close of the taxable year 1965 which is attributable to services performed during the taxable year 1964 will not satisfy the requirement as to receipt of section 911(c)(4) and, therefore, will in no event be excludable under section 911(a).

Subparagraph (A) of section 911(c)(5) provides that no amount received as a pension or annuity may be excluded under section 911(a). The result is the same whether the recipient of such pension or annuity is a resident or a nonresident of the United States. Subparagraph (B) provides that no amount included in gross income by reason of section 402(b) (relating to taxability of beneficiary of nonexempt trust), section 403(c) (relating to taxability of beneficiary under a nonqualified annuity), or section 403(d) (relating to taxability of beneficiary under certain forfeitable contracts purchased by exempt organizations) may be excluded under section 911(a). Thus, amounts contributed by an employer to certain plans which do not qualify under section 401 and in which an individual has nonforfeitable rights, must be included in such individual's gross income currently. The amounts of such contributions are not excludable under section 911(a).

Your committee has added a new paragraph (6) to section 911(c) which provides that a statement by an individual who has earned income from sources within a foreign country that he is not a resident of such country, if he is held not subject as a resident of that country to the income tax of that country by its authorities with respect to such earnings, shall be conclusive evidence that he is not a bona fide resident of that country for purposes of section 911(a)(1).

Your committee has also added a new paragraph (7) to section 911(c) which provides that if an individual receives compensation from sources without the United States (except from the United

States or any agency thereof) in the form of a right to use property or facilities, the limitation under section 911(c)(1) applicable with respect to such individual, (A) for a taxable year ending in 1963, shall be increased by an amount equal to the amount of such compensation so received during such year; (B) for a taxable year ending in 1964, shall be increased by an amount equal to two-thirds of such compensation so received during such year; and (C) for a taxable year ending in 1965, shall be increased by an amount equal to one-third of such compensation so received during such year.

Example 1.—X, a U.S. citizen who files his returns for the calendar year, qualifies under section 911(a) and has been abroad for less than 3 consecutive years. During the taxable years ending December 31, 1963, 1964, 1965, and 1966, X receives compensation in the form of a right to use a residence, such use having a fair market value of $6,000 per year. Under the provisions of section 911(c)(7), the applicable limitation under section 911(c)(1) will be increased in the following amounts:

Taxable year ending:	*Amount*
Dec. 31, 1963	$6,000
Dec. 31, 1964	4,000
Dec. 31, 1965	2,000
Dec. 31, 1966	0

Example 2.—The facts are the same as in example 10 except that X returns and takes up residence in the United States on July 1, 1965. X will be entitled to increase the applicable limitation under section 911(c)(1) for the taxable year ending December 31, 1965, in an amount limited to one-half of $2,000, or $1,000.

(b) *Computation of employees' contributions.*—Existing section 72(f)(2) of the code provides that, in the case of employees' annuities, employees' contributions include amounts contributed by the employer if such amounts would have been exempt from tax had they been paid to the employee directly. Existing law continues to apply to amounts contributed on or before December 31, 1962, for services performed on or before such date.

Subsection (b) of section 11 of the bill amends paragraph (2) of section 72(f) of the code by providing, in general, that such paragraph is not to apply to amounts which were contributed by the employer after December 31, 1962, and which would have been exempt from tax by reason of section 911 had they been paid to the employee directly. However, the preceding sentence does not apply to amounts which were contributed by the employer to provide pension or annuity credits, to the extent such credits are attributable to services performed before January 1, 1963, and are provided pursuant to pension or annuity plan provisions in existence on March 12, 1962, and on that date applicable to such services. Thus, in effect, the first sentence of the amendment contained in section 11(b) of the bill provides that an employee's basis will not be increased by reason of foreign service contributions made by an employer after December 31, 1962, and which would have been exempt from tax by reason of section 911 had they been paid to the employee directly. However, existing law would continue to apply to contributions made after December 31, 1962, to provide benefits attributable to services performed before January 1, 1963, to the extent that (1) such benefits are provided by a plan which is in existence on March 12, 1962, and (2) such con-

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tributions are required to provide the benefits set forth in the plan on March 12, 1962. Thus, certain amounts attributable to services performed before January 1, 1963, and contributed after December 31, 1962, to fund current or past service credits may be added to an employee's basis. However, to the extent benefits are initially provided after March 12, 1962, or to the extent existing benefits are increased after such date, amounts attributable to the new or increased benefits may not be added to an employee's basis even though the new or increased benefits are attributable to services performed before January 1, 1963.

(c) *Effective date.*—Subsection (c) of section 11 of the bill contains the effective date provisions applicable to the amendments to sections 911 and 72(f) of the code.

Paragraph (1) of section 11(c) of the bill provides that, except as provided in paragraph (2), the amendments made by section 11 of the bill are to apply to taxable years ending after December 31, 1962. Paragraph (2) provides that, with respect to the changes in section 911 of the code, the amendment made by section 11(a) of the bill is to apply only with respect to amounts received after December 31, 1962, and which are attributable either, as provided in subparagraph (A), to services performed after such date, or, as provided in subparagraph (B), to services performed on or before such date, but only if on March 12, 1962, there existed no right (whether forfeitable or nonforfeitable) to receive such amounts. Thus, in effect, the effective date provision, with respect to the amendment to section 911, applies existing law to amounts received after December 31, 1962, which are attributable to services performed before January 1, 1963, if on March 12, 1962, a right existed (whether forfeitable or nonforfeitable) to receive such amounts. On the other hand, if amounts are received after December 31, 1962, which are attributable to services performed before January 1, 1963, to which the recipient did not have a right in existence on March 12, 1962, section 911, as amended by section 11 of the bill, will apply to such amounts. In the event a right to receive an amount attributable to services performed before January 1, 1963, existed as of March 12, 1962, and thereafter such amount is increased, section 911, as amended by section 11 of the bill, will apply to such increase.

The application of the provisions of section 11(c)(2) of the bill may be illustrated by the following examples:

Example 1.—A, a U.S. citizen who files his returns on a calendar-year basis, is privately employed and a bona fide resident of Italy for the period January 1, 1961, through December 31, 1963. He is compensated at a rate of $25,000 per year and receives such compensation in the year it is earned. The amounts excludable from gross income for the various calendar years and the applicable provisions of section 911 of the code are as follows: for the years 1961 and 1962, $25,000 under section 911 before amendment by section 11 of the bill; for the year 1963, $20,000 under section 911, as amended by the bill.

Example 2.—A, the taxpayer described in example 1, receives on May 1, 1963, $5,000 as a supplementary salary payment for services performed during the taxable year 1962. Such amount is received pursuant to an agreement in existence on March 12, 1962. Under section 11(c)(2)(B) of the bill, such amount will be subject to section 911 of the code before amendment. The entire supplementary salary

payment will be excludable from gross income under section 911(a)(1) (before amendment).

Example 3.—The facts are the same as in example 2, except that no right to receive the $5,000 supplementary salary payment is in existence on March 12, 1962. Under section 11(c)(2)(B) of the bill, such amount is to be subject to the provisions of section 911, as amended by the bill. Under section 911, as amended, the amount excludable is to be computed under section 911(c). Under section 911(c)(2), the supplementary salary payment is to be considered received in 1962. Under section 911(c)(1), that portion of the amount received which, when added to other qualifying amounts received during the taxable year 1962, does not exceed an amount computed on a daily basis at an annual rate of $20,000 will be excludable. Since, under the facts set forth in example 1, A received excludable amounts in excess of $20,000 during the taxable year 1962, no part of the supplementary salary payment is to be excludable from gross income.

SECTION 12. CONTROLLED FOREIGN CORPORATIONS

(a) *Tax on United States shareholders.*—Subsection (a) of section 12 of the bill, corresponding to section 13 of the bill as passed by the House, adds a new subpart F (secs. 951–964) and a new subpart G (secs. 970–972) to part III of subchapter N of the Internal Revenue Code of 1954.

SECTION 951. AMOUNTS INCLUDED IN GROSS INCOME OF UNITED STATES PERSONS

(a) *Amounts included.*—Subsection (a) provides that, if a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during its taxable year, then any United States person who is a United States shareholder (as defined in subsection (b)) and who owns (within the meaning of section 958(a)) stock in such corporation, on the last day of such taxable year on which it was a controlled foreign corporation must include in gross income for his taxable year (in which or with which ends the taxable year of the controlled foreign corporation) the sum of (except as provided by section 963, relating to the receipt of minimum distributions):

(1) his pro rata share of the corporation's subpart F income for its taxable year, and his pro rata share of the corporation's previously excluded subpart F income withdrawn from investment in less developed countries for such year; and

(2) his pro rata share of the corporation's increase in earnings invested in United States property for its taxable year which is not excluded from gross income under section 959(a)(2).

The pro rata shares are included in the income of the United States shareholder even though there may be intervening entities in a chain between the controlled foreign corporation and such shareholder. The pro rata share to be included by the United States shareholder (if the corporation is a controlled foreign corporation for its entire taxable year) is that amount which would have been distributed with respect to the ownership interest of such person if the corporation had distributed the total amount of its subpart F income, the total of its previously excluded subpart F income withdrawn from investment in

less developed country corporations, and the total of the increase in its earnings invested in United States property on the last day of its taxable year. If the corporation is a controlled foreign corporation for only part of its taxable year, paragraphs (2), (3), and (4) of section 951(a) provide that the pro rata share is that which would have been distributed (on the last day of the corporation's taxable year on which it was a controlled foreign corporation) if the controlled foreign corporation had distributed pro rata an amount which bears to such total amount the same ratio that the part of the year during which the corporation was a controlled foreign corporation bears to the entire taxable year.

Example (1).—X, a United States shareholder, wholly owns throughout 1965 Y, a controlled foreign corporation, which has $50 of subpart F income, $50 of previously excluded subpart F income withdrawn from investment in less developed countries, and $100 of earnings and profits for its taxable year 1965. Both X and Y use a calendar year as their taxable year. X, for taxable year 1965, must include $100 ($50+$50) in gross income as if such amount had been distributed on December 31, 1965.

Example (2).—X and T, United States shareholders with the calendar year as a taxable year, each acquire on July 1, 1963, 30 percent of the voting stock of Y, a foreign corporation (having only one class of stock) which became, as of that day, a controlled foreign corporation. Y has no subpart F income or previously excluded subpart F income withdrawn from investment in less developed countries, has $100 of earnings and profits, and has a $100 increase in earnings invested in United States property, for its 1963 taxable year (also a calendar year). For their 1963 taxable year, X and T each must include in gross income $15, the amount which would have been distributed with respect to their stock if Y had distributed pro rata ½ of $100, or $50 on December 31, 1963.

An increase in earnings invested in United States property is included in gross income only to the extent that it exceeds the subpart F income for the current taxable year and previous taxable years, but only if such subpart F income (here used to include subpart F income previously excluded because of qualified investment in less developed countries but now withdrawn from such investment) has not already been so used as an offset or has not been actually distributed in a previous taxable year. Distributions from subpart F income and from amounts taxed under section 951(a)(1)(B) as increases in earnings invested in United States property are excluded from gross income under section 959. Rules for allocation of distributions to subpart F income, increases in earnings invested in United States property, or other earnings and profits are made under the rules of section 959(c).

In a case in which stock of a controlled foreign corporation is transferred by any person to a United States shareholder during a taxable year, if the transferor receives a distribution with respect to such stock, the acquiring shareholder, under section 951(a)(2)(B), may reduce the amount he would otherwise be required to include in gross income under section 951(a)(1)(A)(i) by the amount of such dividend. The corresponding provision of the bill as passed by the House applied only to transfers among United States persons. Section 951(a)(2)(B) also provides a limitation (not contained in the bill as passed by the House) that the reduction is only to the extent the

amount of the distribution with respect to stock by the corporation does not exceed the distribution which would have been distributed with respect to such stock if the corporation had distributed an amount which bears the same ratio to subpart F income of the corporation for the taxable year as the part of such year during which such shareholder did not own (within the meaning of section 958(a)) such stock bears to the entire year. The exclusion applies only where the dividend is paid to a person outside the chain of ownership described in section 958(a)(2) since otherwise the United States person is a United States shareholder both before and after the transfer.

Example (1).—Assume that A, a United States shareholder, owns 20 percent of the one class of stock in Z, a controlled foreign corporation, and that on July 1, 1963, immediately after receiving a $12 dividend, A transfers the stock to B, a United States shareholder. A, B, and Z use the calendar year as the taxable year. Z's entire earnings and profits for 1963 consists of $100 all of which is subpart F income. A must include in gross income the $12 dividend. B must include in his gross income for 1963, $10, computed as follows:

(*a*) The amount distributed by the controlled foreign corporation ($12÷20 percent)	$60
(*b*) Limitation on the distribution ($100×6/12)	50
(*c*) Limitation on the reduction (20 percent of $50)	10
(*d*) Amount included in gross income under section 951(a)(1)(A)(i) ($20 minus $10)	10

Example (2).—A, a United States shareholder, owns all the one class of stock of Y, a foreign corporation, which in turn owns all the one class of stock in Z which for its taxable year has $100 subpart F income. A, Y, and Z, each uses the calendar year as the taxable year. On July 1, Z distributes $100 to Y. A must include in gross income $100 of Z's subpart F income, unreduced under section 951(a)(2)(B) by the distribution by Z since A is the owner of the Z stock within the meaning of section 958(a) for the entire year.

Example (3).—The facts are the same as in example (2) except that A acquired the stock in Y from B (not in the chain of ownership described in section 958(a)(2)) on July 1, and that Z, immediately before the transfer, distributed $50 to B. Under section 951(a)(2)(B) the $100 otherwise required to be included in X's gross income is reduced by $50.

(b) *United States shareholder defined.*—Subsection (b) defines "United States shareholder" with respect to any foreign corporation to mean a United States person (as defined in section 957(d)) who owns under section 958(a), or is considered as owning under section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation. Only a United States shareholder as thus defined is taxable under section 951 or is taken into account in determining whether there exists the United States ownership of a foreign corporation required to constitute it a controlled foreign corporation. The bill as passed by the House, in determining whether a corporation is a controlled foreign corporation, took into account any U.S. person who under the provisions corresponding to section 958(b) owned stock in the foreign corporation even though such person owned (under section 958(b)) less than 10 percent of the total combined voting power of all classes of stock entitled to vote in the corporation. Also, once a foreign corporation was classed as a controlled foreign corporation, the bill as

passed by the House taxed a United States person who owned 10 percent of the value of the stock in the corporation, notwithstanding that his stock entailed no voting power.

Example.—H owns (under section 958(a)) 5 percent of the one class of stock of X, a controlled foreign corporation, and his wife, W, owns (under section 958(a)) 10 percent of the stock of such corporation. Under the rules of section 958(b), H is considered to own 15 percent of the stock of X and will be required to include in gross income amounts attributable to his 5 percent interest as determined under section 958(a). W will be required to include in gross income amounts attributable to her 10 percent of the stock of such corporation.

(c) *Coordination with election of a foreign investment company to distribute income.*—Subsection (c) provides that a United States person who, for his taxable year, is a qualified shareholder, within the meaning of section 1247(c), of a foreign investment company with respect to which an election under section 1247 is in effect is not required to include in gross income under subsection (a) for such year any income of such company. The corresponding provision of the bill as passed by the House applied only to subpart F income.

(d) *Coordination with foreign personal holding company provisions.*—Subsection (d) provides that a United States shareholder who, for a taxable year, is subject to tax under section 551(b) (relating to foreign personal holding company income included in gross income of United States shareholders) on income of a controlled foreign corporation is not required to include in gross income, for such taxable year, any amount under subsection (a) with respect to such company. The corresponding provision of the bill as passed by the House (sec. 13(b)(1)) amended section 551(b) to provide that the amount of undistributed foreign personal holding company income otherwise required under section 551(b) to be included in gross income of a United States person is reduced by his proportionate share of undistributed foreign personal holding company income included in gross income under section 951(a) for the taxable year as his proportionate share of subpart F income of such controlled foreign corporation.

SECTION 952. SUBPART F INCOME DEFINED

Section 952 defines the two types of income of a controlled foreign corporation which constitute "subpart F income" and may be includible in the gross income of United States shareholders under section 951(a)(1)(A).

(a) *In general.*—Paragraph (1) of section 952(a) provides that the subpart F income of a controlled foreign corporation, for purposes of section 951(a)(1)(A), is the sum of (1) the income of the controlled foreign corporation derived from insurance of United States risks as determined under section 953; and (2) the foreign base company income of a controlled foreign corporation, as determined under section 954. The provision in the bill as passed by the House which included in subpart F income the income of the controlled foreign corporation from United States patents, copyrights, and exclusive formulas and processes has been deleted from subpart F; but see section 16 of the bill as reported by your committee for provisions relating to the transfer of such rights to a controlled foreign corporation.

(b) *Exclusion of United States income.*—Subsection (b) excludes, from subpart F income, amounts includible in gross income under chapter 1 of the code (other than the new subpart F) where the controlled foreign corporation is engaged in trade or business in the United States and such income is treated as income from sources within the United States. This subsection will not permit an exclusion from subpart F income in the case of United States source income of a controlled foreign corporation having no permanent establishment in the United States in situations (involving tax treaties) in which such permanent establishment is a requisite to imposition of United States tax, since in such a situation no amount will have been included in gross income for purposes of this section.

(c) *Limitation.*—Section 952(c), corresponding to section 952 (a)(3) of the bill as passed by the House, provides that the subpart F income of a controlled foreign corporation for any taxable year of such corporation may not exceed the earnings and profits of the controlled foreign corporation for that year but with a reduction not provided for by the bill as passed by the House. The reduction is the amount (if any) by which—

> (1) the sum of the deficits in earnings and profits for prior taxable years beginning after December 31, 1959 (reduced by any earnings and profits for taxable years beginning after December 31, 1959, and before January 1, 1963), exceeds
>
> (2) an amount equal to the earnings and profits described in section 959(c)(3) accumulated for taxable years beginning after December 31, 1962, determined as of the close of the preceding taxable year.

For such purpose a deficit for a prior taxable year is taken into account only to the extent it has not been taken into account for any preceding taxable year.

Example (1).—M, a controlled foreign corporation, has subpart F income for taxable year 1963, before applying subsection (c), of $100. Deductions not allocable to such income exceed gross income (other than gross income giving rise to subpart F income) by $25 with the result that earnings and profits for the year are $100 minus $25, or $75. M's subpart F income for 1963 as limited by subsection (c) is $75.

Example (2).—In 1963 a controlled foreign corporation has earnings and profits of $90,000, consisting of $40,000 of subpart F income and $50,000 of other income. For taxable year 1964, the corporation has a deficit in earnings and profits of $400,000. In 1965 it has earnings and profits of $380,000, consisting of subpart F income of $300,000 and other income of $80,000. It makes no distributions during 1963, 1964, or 1965. Under subsection (c), the limitation for 1965 is $30,000 computed as follows:

Earnings and profits for 1965		$380,000
Reduced by deficit for 1964	$400,000	
Less:		
Earnings and profits described in sec. 959(c)(3) accumulated as of close of 1964 (without reduction by the 1964 deficit)	50,000	
		350,000
Limitation under subsection (c)		30,000

(d) *Special rule in case of indirect ownership.*—Subsection (d) provides a special rule that, for purposes of the limitation in subsection (c), the earnings and profits of a controlled foreign corporation for a taxable year are reduced not only by the deficits of such controlled foreign corporation as provided in subsection (c), but also by the deficits of certain other foreign corporations. The special rule is that if a United States shareholder owns (within the meaning of section 958(a)) stock of a foreign corporation and by reason of such ownership owns (within the meaning of such section) stock of any other foreign corporation, and any of such foreign corporations has a deficit in earnings and profits for the taxable year, then earnings and profits of each such foreign corporation which is a controlled foreign corporation is, with respect to such shareholder, reduced to take account of such deficit in such manner as the Secretary of the Treasury or his delegate may prescribe by regulations.

SECTION 953. INCOME FROM INSURANCE OF UNITED STATES RISKS

Section 953, corresponding to section 952(b) of the bill as passed by the House, defines the term "income derived from insurance of United States risks" referred to in section 952(a)(1) as one item included in subpart F income.

(a) *General rule.*—Subsection (a) provides that income derived from the insurance of United States risks is that income which would (subject to certain modifications) be taxed under subchapter L of chapter 1 if the controlled foreign corporation were a domestic insurance corporation. Such income is included in subpart F income, however, only if attributable to the reinsurance or the issuing of any insurance or annuity contract (A) in connection with property in or liability arising out of activity in, or in connection with the lives or health of, residents of the United States, or (B) in connection with risks which are not included in subparagraph (A) because of an arrangement whereby another corporation receives a substantially equal amount of premiums or other consideration in respect of reinsurance or the issuing of any insurance or annuity contract in connection with property in or liability arising out of activity in, or in connection with the lives or health of, residents of the United States. The definition is the same as that in the bill as passed by the House except for changes which are clerical and which make clear that the contract must be in connection with property in or liability arising out of activity in the United States or in connection with the life or health of residents of the United States. Your committee has added a new sentence at the end of subsection (a) which provides that section 953 applies only in the case of a controlled foreign corporation which receives, during any taxable year, premiums or other consideration in respect of contracts described above in excess of 5 percent of the total premiums and other consideration received during the taxable year in respect of all reinsurance and issuing of insurance and annuity contracts.

(b) *Special rules.*—Subsection (b), which is the same, except for conforming changes, as section 952(b)(2) of the bill as passed by the House, provides special rules which modify the application of subchapter L for purposes of subsection (a).

Under paragraph (1), respecting the application of part I of subchapter L, life insurance company taxable income is defined solely as

the gain from operations under section 809(b) despite the provisions of section 802(b).

Under paragraph (2), the taxable income of all insurance companies other than life insurance companies, that is, both mutual and stock insurance companies which are ordinarily subject to the provisions of part II or part III of subchapter L, respectively, is to be determined under part III of subchapter L.

Paragraph (3) disallows certain deductions from income for purposes of this subsection. These deductions are:

(A) Section 809(d)(4) (operations loss deduction),

(B) Section 809(d)(5) (certain nonparticipating contracts),

(C) Section 809(d)(6) (group life, accident, and health insurance),

(D) Section 809(d)(10) (small business deduction),

(E) Section 817(b) (gain on property held on December 31, 1958, and certain substituted property acquired after 1958), and

(F) Section 832(b)(5) (certain capital losses).

Under paragraph (4) "gross amount" (in section 809(c)(1)), net decrease in reserves (in section 809(c)(2)), "increases in certain reserves" (defined in section 809(d)(2)), and premiums earned (defined in section 832(b)(4)) are taken into account only to the extent in respect of any reinsurance or the issuing of any insurance or annuity contract described in subsection (a)(1) of section 953.

Under paragraph (5), all other items of income, that is items other than those taken into account under paragraph (4), as well as all items of expenses, losses, and deductions shall be properly allocated under regulations prescribed by the Secretary of the Treasury or his delegate.

SECTION 954. FOREIGN BASE COMPANY INCOME

(a) *Foreign base company income.*—Subsection (a), corresponding to section 952(e) of the bill as passed by the House, defines foreign base company income as the sum of three items, each reduced by deductions properly allocable to such items: (1) foreign personal holding company income, (2) foreign base company sales income, and (3) foreign base company services income. The bill as passed by the House contained no provision corresponding to item (3).

(b) *Exclusions and special rules.*—Paragraph (1) provides an exclusion from foreign base company income for (A) dividends and interest received during the taxable year from investments which at the time of receipt are qualified investments in less developed countries, or (B) gains from the sale or exchange during the taxable year of investments which at the time of sale or exchange are qualified investments in less developed countries to the extent that gains from such sales or exchanges exceed the losses from such sales or exchanges. The preceding exclusion is limited to the increase for the taxable year in qualified investments in less developed countries. The bill as passed by the House contained a provision for the reduction of foreign base company income by the amount of any increase in qualified investments in less developed countries, with different terms of qualification discussed under section 955(b).

Example.—O, a controlled foreign corporation, has for taxable year 1965 subpart F income of $100 which includes $50 of foreign

base company income of which $40 consists of dividends from qualified investments in less developed countries. O's increase for the taxable year in qualified investments in less developed countries is $30. O may exclude from foreign base company income $30 under section 954(b)(1) and will, accordingly, include in gross income foreign base company income of only $20.

Paragraph (2) of section 954(b) provides that foreign base company income does not include income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce, or the performance of services directly related to the use of any such aircraft or vessel.

Paragraph (3), corresponding to paragraph (6) of section 952(e) of the bill as passed by the House, provides that, if the foreign base company income for the taxable year is less than 30 percent of gross income, no part of the income is to be treated as foreign base company income, but if foreign base company income for the taxable year exceeds 70 percent of gross income, the entire gross income is, subject to the provisions of paragraphs (1), (2), (4), and (5) of section 954(b), to be treated as foreign base company income. The corresponding percentages in the bill as passed by the House were 20 percent and 80 percent, respectively. The reduction of subpart F income provided by subpart G (Export Trade Corporations) does not affect the determinations of the 30 and 70 percent lines.

Paragraph (4) provides that foreign base company income does not include any item of income with respect to which it is established to the satisfaction of the Secretary of the Treasury or his delegate that the creation or organization of the controlled foreign corporation receiving such item under the laws of the country in which it is incorporated does not have the effect of substantial reduction of income, war profits, or excess profits taxes or similar taxes.

The determination of whether the creation or organization of a controlled foreign corporation has the effect of substantially reducing income, war profits, excess profits taxes or similar taxes depends upon all the facts and circumstances including the effective rate of tax and the extent to which it has been reduced.

Paragraph (5), corresponding to section 952(e)(7) of the bill as passed by the House, provides that the foreign personal holding company income, the foreign base company sales income, and the foreign base company services income are reduced, under regulations prescribed by the Secretary of the Treasury or his delegate, so as to take into account deductions (including taxes) properly allocable to such income.

(c) *Foreign personal holding company income.*—Subsection (c) is similar to section 952(e) of the bill as passed by the House, and defines foreign personal holding company income, for purposes of section 954(a)(1), as foreign personal holding company income (as defined in section 553) with the modifications and adjustments provided in paragraphs (2), (3), and (4) of section 954(c).

Paragraph (2) provides that all rents are included in foreign personal holding company income without regard to whether or not such rents constitute 50 percent or more of gross income. Section 553 already achieves such a result as to royalties.

Paragraph (3) excludes from personal holding company income (A) rents and royalties derived in the active conduct of a trade or business, (B) or dividends, interest and gains from the sale or exchange of stock

or securities derived in the conduct of a banking, financing, or similar business, or derived from the investments by an insurance company of its unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business. The exclusion applies, however, only to amounts received from a person other than a related person.

Paragraph (4) excludes certain income received from related persons:

(A) dividends and interest from a related person which (i) is organized under the laws of the same foreign country under the laws of which the controlled foreign corporation is created or organized and (ii) has a substantial part of its assets used in its trade or business located in such same foreign country;

(B) interest received in the conduct of a banking, financing, or similar business from a related person engaged in the same type of business provided the business of the payor and the recipient are predominantly with persons other than related persons; and

(C) rents, royalties, and similar amounts received from a related person for the use of, or privilege of using, property within the country under the laws of which the controlled foreign corporation is created or organized.

(d) *Foreign base company sales income.*—Paragraph (1) of subsection (d) corresponds to section 952(e)(2) of the bill as passed by the House and defines foreign base company sales income as income (whether in the form of profits, commissions, fees, or otherwise) derived in connection with:

(1) the purchase of personal property from a related person and its sale to any person,

(2) the sale of personal property to any person on behalf of a related person,

(3) the purchase of personal property from any person and its sale to a related person, or

(4) the purchase of personal property from any person on behalf of a related person,

where (A) the property which is purchased (or in the case of property sold on behalf of a related person, the property which is sold) is manufactured, produced, grown, or extracted outside the country under the laws of which the controlled foreign corporation is created or organized, and (B) the property is sold for use, consumption, or disposition outside such foreign country, or, in the case of property purchased on behalf of a related person, is purchased for use, consumption, or disposition outside such foreign country.

The definition does not apply to income of a controlled foreign corporation from the sale of a product which it manufactures. In a case in which a controlled foreign corporation purchases parts or materials which it then transforms or incorporates into a final product, income from the sale of the final product would not be foreign base company sales income if the corporation substantially transforms the parts or materials, so that, in effect, the final product is not the property purchased. Manufacturing and construction activities (and production, processing, or assembling activities which are substantial in nature) would generally involve substantial transformation of purchased parts or materials.

Where the definition of foreign base company sales income depends on whether property is sold for use, consumption, or disposition out-

side the country under the laws of which the controlled foreign corporation is created or organized, a destination test applies. Generally property will be considered to be used, consumed, or disposed of in the country to which it is delivered unless circumstances indicate that the property is to be exported after it is so delivered.

Paragraph (2) of section 954(d) provides that in situations in which the carrying on of activities by a controlled foreign corporation through a branch or similar establishment outside the country of incorporation of the controlled foreign corporation has substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation deriving such income, then, under regulations prescribed by the Secretary of the Treasury or his delegate, the income attributable to the carrying on of such activities of such branch or similar establishment shall be treated as income derived by a wholly owned subsidiary of the controlled foreign corporation and shall constitute foreign base company sales income of the controlled foreign corporation. Determinations, such as those required under section 954 (b)(3) and (d)(1) (A) and (B), as to such branch income shall be made as though such branch were a separate controlled foreign corporation.

Paragraph (3), corresponding to the last sentence of section 952(e)(2) of the bill as passed by the House, provides that a person is a related person with respect to a controlled foreign corporation, if such a person is—

(A) an individual, trust, or estate which controls such corporation;

(B) a corporation which controls, or is controlled by, the controlled foreign corporation;

(C) a corporation which is controlled by the same person or persons which control the controlled foreign corporation.

For purposes of such paragraph, control means the ownership, directly or indirectly, of stock (determined under section 958) possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote.

The bill as passed by the House provided in section 952(e)(2) that foreign base company income included foreign base company sales income if, for the taxable year, such income was equal to at least 20 percent of the gross income of the foreign corporation. Your committee's amendment provides no comparable limitation with respect to foreign base company sales income but, as discussed above, it provides in section 954(a)(2) a 30-percent limitation which is applicable to total foreign base company income.

(e) *Foreign base company services income.*—Subsection (e) defines foreign base company services income as that income (whether in the form of compensation, commissions, fees, or otherwise) derived in connection with technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which are performed—

(1) for or on behalf of a related person, and

(2) outside the country under the laws of which the controlled foreign corporation is created or organized.

Such rule, however, does not apply to income derived from services which are directly related to the sale or exchange of property manufactured, produced, grown, or extracted by the controlled foreign corporation and which are performed before the sale or exchange, or

derived from services directly related to an offer or effort to sell or exchange such property.

(f) *Increase in qualified investments in less developed countries.*—Subsection (f) provides the rule for determining the increase for a taxable year in qualified investments in less developed countries. This amount constitutes a limitation on the exclusion of dividends, interest, and gains from qualified investments in less developed countries and requires, in effect, that such dividends, interest, and gains be reinvested in qualified investments in less developed countries. The increase for a taxable year is the amount by which a controlled foreign corporation's qualified investment in less developed countries at the close of its taxable year exceeds such investments at the close of the preceding taxable year.

SECTION 955. WITHDRAWAL OF PREVIOUSLY EXCLUDED SUBPART F INCOME FROM QUALIFIED INVESTMENT

(a) *In general.*—Subsection (a) provides rules relating to previously excluded subpart F income withdrawn from investment in less developed countries which is includible in gross income of a United States shareholder under section 951(a)(1)(A)(ii).

Paragraphs (1) and (2) of section 955(a) define the amount of subpart F income withdrawn from investment in less developed countries and set forth the limitations on including such amount in gross income. The amount withdrawn is an amount equal to the decrease in qualified investments in less developed countries for the taxable year provided such decrease does not exceed the sum of the amounts excluded from foreign base company income under section 954(b)(1) for all prior taxable years reduced by the sum of amounts of previously excluded subpart F income withdrawn from investments in less developed countries for all prior taxable years. Further, such decrease must be reduced by the amount (if any) by which losses exceed gains on dispositions of qualified investments in less developed countries and, after application of such losses, such decrease may not exceed the sum of earnings and profits for the current year and all prior taxable years beginning after December 31, 1962.

Example (1).—X, a United States shareholder and sole owner of M, a controlled foreign corporation, determines the amount includible in gross income under section 951(a)(1)(A)(ii) for the taxable year as follows:

(1) Decrease in qualified investments in less developed countries for the taxable year		50
(2) Excess of losses over gains on dispositions of qualified investments in less developed countries during the taxable year		10
(3) Earnings and profits for the current taxable year and all prior taxable years beginning after December 31, 1962		45
(4) Section 955(a)(1) (A) and (B) limitation: Amounts excluded from foreign base company income under section 954(b)(1) for all prior taxable years	75	
Less: amounts of previously excluded subpart F income withdrawn from qualified investments in less developed countries for all prior taxable years	25	50
(5) Amount includible in gross income under section 951(a)(1)(A)(ii) for the taxable year (item 1 reduced by item 2 to the extent not in excess of the lesser of items 3 or 4)		40

Example (2).—The facts are the same as in example (1) except that earnings and profits for the current taxable year and all prior taxable years are 35 instead of 45. The amount includible in gross income under section 951(a)(1)(A)(ii) for the taxable year is 35 (item 1 reduced by item 2 and limited by item 3 to the extent not in excess of item 4).

Example (3).—The facts are the same as in example (1) except the section 955(a)(1) (A) and (B) limitation (item 4) is 30 instead of 50. The amount includible in gross income under section 951(a)(1)(A)(ii) for the taxable year is 30 (item 1 reduced by item 2 limited by item 4 and not in excess of item 3).

Paragraph (3) provides that a United States shareholder's pro rata share of the amount of previously excluded subpart F income of a controlled foreign corporation withdrawn from investment in less developed countries for a taxable year is his pro rata share of the amount determined under paragraph (1).

(b) *Qualified investments in less developed countries.*—Subsection (b) defines qualified investments in less developed countries as property which is—

(A) stock of a less developed country corporation but only if the controlled foreign corporation owns 10 percent or more of the total combined voting power of such less developed country corporation;

(B) an obligation of a less developed country corporation which at the time of its acquisition by the controlled foreign corporation has a maturity of 5 years or more, but only if the controlled foreign corporation owns 10 percent or more of the total combined voting power of all classes of stock of such less developed country corporation; or

(C) an obligation of a less developed country.

For purposes of this section, an obligation of a less developed country includes, wherever appropriate, obligations issued or guaranteed by the government of a less developed country or a political subdivision thereof and obligations of an agency, instrumentality or other "alter ego" of a government of a less developed country. Because of the variety of legal forms that may be involved, the provision refers only to the essential condition that a less developed country be financially committed in the obligation.

Paragraph (2) provides that property which would be a qualified investment in less developed countries but for the fact that the foreign country, after the property was acquired, ceased to be a less developed country shall be treated as a qualified investment in less developed countries.

Paragraph (3) provides that a controlled foreign corporation may, under regulations prescribed by the Secretary of the Treasury or his delegate, elect to treat qualified investments in a less developed country as acquired during the taxable year although actually acquired during the following taxable year or on or before such day after the close of the following taxable year as such regulations may prescribe.

Paragraph (4) provides that the amount taken into account with respect to property described in paragraph (1) or (2) shall be its adjusted basis, reduced by any liability to which such property is subject.

(c) *Less developed country corporations.*—Subsection (c) defines a less developed country corporation as a foreign corporation which is created or organized under the laws of a less developed country and which during the taxable year is engaged in the active conduct of one or more trades or businesses and—

(A) at least 80 percent of whose gross income for such year is derived from sources within less developed countries, and

(B) at least 80 percent in the value of whose assets on each day of the taxable year consists of—

(i) property used in such trades or businesses and located in less developed countries,

(ii) money, and deposits with persons carrying on the banking business,

(iii) stock, and obligations which, at the time of their acquisition, have at least a 5-year maturity, of any other less developed country corporation,

(iv) obligations of a less developed country,

(v) an investment required because of restrictions imposed by a less developed country, and

(vi) property described in section 956(b)(2) relating to exceptions from the term United States property.

For purposes of section 955(c)(1)(A), whether income is derived from sources within less developed countries shall be determined under regulations prescribed by the Secretary of the Treasury or his delegate. The source rules prescribed under such regulations, to be used in determining whether income is derived from sources within one foreign country or another, need not be analagous to the rules used in determining whether or not income is derived from sources within the United States.

Paragraph (2) provides that the term "less developed country corporation" also includes a foreign corporation 80 percent or more of the assets of which on each day of the taxable year consists of assets used, or held for use, for or in connection with production of income described below and property described in section 956(b)(2), relating to exceptions from the term United States property, and 80 percent or more of the gross income of which consists of:

(A) gross income derived from, or in connection with, the using (or hiring or leasing for use) in foreign commerce of aircraft or vessels registered under the laws of a less developed country, or from, or in connection with, the performance of services directly related to use of such aircraft or vessels, or from the sale or exchange of such aircraft or vessels, or

(B) dividends and interest received from foreign corporations which are less developed country corporations within the meaning of this paragraph and 10 percent or more of the total combined voting power of all classes of stock of which are owned by the foreign corporation, and gain from the sale or exchange of stock or obligations of foreign corporations which are such less developed country corporations.

The 80-percent gross income requirement can be satisfied by a combination of the amounts described in subparagraphs (A) and (B).

Paragraph (3), which is identical to section 953(b)(5) of the bill as passed by the House, except for one new rule, defines less developed country. Except for certain countries and areas specified in the paragraph which may not be designated as less developed countries,

the designation of which countries are less developed is left to Executive order. The new rule is that termination of a designation of a country as a less developed country may not be made until 30 days after notice by the President to the Senate and the House of Representatives of his intention to make the termination.

SECTION 956. INVESTMENT OF EARNINGS IN UNITED STATES PROPERTY

Section 956 provides rules for determining the amount includible in gross income under section 951(a)(1)(B) as a United States shareholder's pro rata share of the controlled foreign corporation's increase in earnings invested in United States property. A similar provision of the bill as passed by the House, section 953, applied to investments in nonqualified property which included not only United States property but also property other than that ordinary and necessary for the active conduct of an existing trade or business and other than certain investments in corporations incorporated in less developed countries and actively carrying on a trade or business almost wholly within such countries.

(a) *Determination of the amount of the investment.*—Paragraph (1) of section 956(a) provides that the amount of earnings of a controlled foreign corporation invested in United States property at the end of any taxable year is the aggregate amount of such property held at the close of the taxable year, to the extent such amount would have constituted a dividend if it had been distributed. For such purpose, however, earnings and profits does not include amounts attributable to previously excluded subpart F income withdrawn from less developed countries during the taxable year.

Paragraph (2) of section 956(a) provides that the increase for any taxable year of a United States shareholder's pro rata share of the earnings of a controlled foreign corporation invested in United States property is the amount determined by subtracting, from his pro rata share of the amount determined under paragraph (1) for the close of the taxable year, his pro rata share of the amount determined under paragraph (1) for the close of the preceding taxable year, reduced by amounts distributed during such preceding taxable year to which section 959(c)(1) applies, that is, reduced by distributed amounts which have been excluded from gross income because they are earnings and profits previously taxed as increases in earnings invested in United States property. Such determination is made on the basis of stock owned under section 958(a) on the last day during the taxable year on which the foreign corporation is a controlled foreign corporation.

Example.—X is a United States shareholder and 100-percent owner of controlled foreign corporation M. M's investment in United States property determined under section 956(a)(1) at the close of the taxable year 1964 was $150 and its accumulated earnings and profits at the beginning of the taxable year 1965 was $175, $100 of which were described in section 959(c)(1), $50 of which were described in section 959(c)(2), and $25 of which were described in section 959(c)(3). During the taxable year 1965, M had earnings and profits of $50, $35 of which were subpart F income and M withdrew $10 of previously excluded subpart F income from qualified investments in less developed countries. M distributed $50 to which section 959(c)(1) applies during the preceding taxable year 1964. The total United States prop-

erty held by M at the close of the taxable year 1965 is $250. X determines the amount includible in his gross income under section 951(a)(1)(B) as follows:

(1) Amount of United States property held at the close of the taxable year 1965		$250
(2) Amount of item (1) which would have constituted a dividend if distributed (item (1) to extent not in excess of earnings and profits at December 31, 1965 of $225)		225
(3) Determination of pro rata increase in investment in United States property for the taxable year 1965:		
Amount determined under section 956(a)(1) at close of taxable year 1965	$225	
Amount determined under section 956(a)(1) at close of preceding taxable year, reduced by amounts paid to which section 959(c)(1) applies during such preceding taxable year ($150 minus $50)	100	
		125
(4) Amount includible in gross income under section 951(a)(1)(B):		
Pro rata increase in investment in United States property	125	
Less: Previously taxed subpart F income ($50 in prior years and $35 in current year) and previously excluded subpart F income withdrawn from qualified investments ($10)	95	
		30

Paragraph (3) of section 956(a) provides that the amount taken into account under paragraphs (1) or (2) with respect to any property is to be its adjusted basis, reduced by any liability to which the property is subject.

(b) *United States property defined.*—Paragraph (1) of subsection 956(b) provides the general rule that United States property means property acquired after December 31, 1962, which is tangible property located in the United States; stock of a domestic corporation; an obligation of a United States person; any right to the use in the United States of a patent or copyright, an invention, model, or design (whether or not patented), a secret formula or process, or any similar property right, which is acquired or developed by the controlled foreign corporation for use in the United States.

Paragraph (2) excepts property from United States property if it is referred to in subparagraphs (A) through (F). Subparagraph (A) refers to obligations of the United States, money, or deposits with persons carrying on the banking business. Subparagraph (B) refers to property located in the United States purchased in the United States for export to, or for use in, foreign countries. Subparagraph (C) refers to any obligation of a United States person arising in connection with the sale or processing of property, if the amount of such obligation outstanding at no time during the taxable year exceeds the amount which would be ordinary and necessary to carry on the trade or business of both the other party to such sale or processing transaction and the United States person had such transaction been made between unrelated persons.

Subparagraph (D) refers to aircraft, railroad rolling stock, vessels, motor vehicles, or containers, used in the transportation of persons or property in foreign commerce and used predominantly outside the United States. Subparagraph (E) refers to insurance company assets equivalent to the unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business with respect to

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contracts not described in section 953(a)(1). Subparagraph (F) refers to an amount of assets of the controlled foreign corporation equal to the earnings and profits accumulated after December 31, 1962, and excluded from gross income under section 952(b), relating to the exclusion of certain United States income.

(c) *Pledges and guarantees.*—Subsection (c) provides that a controlled foreign corporation, under regulations by the Secretary of the Treasury or his delegate, is considered to hold an obligation of a United States person if it is a pledgor or guarantor of such obligation.

SECTION 957. CONTROLLED FOREIGN CORPORATIONS; UNITED STATES PERSONS

(a) *Controlled foreign corporations defined.*—Subsection (a), corresponding to section 954(a) of the bill as passed by the House, defines controlled foreign corporation for purposes of the new subpart F, as a foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned by United States shareholders (defined in section 951(b) to include only United States persons owning or considered as owning 10 percent or more of such stock) on any day during the taxable year of the corporation. In this connection, constructive rules of ownership provided in section 958 apply. The bill as passed by the House, to determine whether ownership of more than 50 percent exists in the United States, took account of any stock interest (even if less than 10 percent) owned by a United States person.

(b) *Special rule for insurance.*—Subsection (b), corresponding to section 954(b) of the bill as passed by the House, provides a special definition of controlled foreign corporations solely for the purpose of including the income derived from insurance of United States risks, referred to in section 953(a), in the gross income of a United States shareholder. Under the special definition "controlled foreign corporation" includes not only a foreign corporation satisfying subsection (a) but also one of which more than 25 percent of the total combined voting power of all classes of stock is owned under section 958 by United States shareholders, on any day during the taxable year of a corporation, if the gross amount of premiums or other consideration in respect of any reinsurance or issuing of insurance or annuity contracts described in section 953(a)(1), exceeds 75 percent of the gross amount of all premiums or other consideration in respect of all risks. Only the subpart F income consisting of income from insurance of United States risks is required to be included in the gross income of a United States person owning stock in a corporation satisfying subsection (b) but not subsection (a).

(c) *Corporations organized in United States possessions.*—Subsection (c) excepts from the definition of "controlled foreign corporation" a corporation created or organized in Puerto Rico or a United States possession. In order to qualify for the exception, the corporation must derive at least 80 percent of its gross income for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately before the end of such taxable year as may be applicable) from sources within Puerto Rico or a United States possession. In addition, 50 percent of its gross income for such period (or part thereof) must be derived from the active conduct within Puerto Rico or a United States possession of certain specified trades or

businesses. The statutory language for this requirement is adapted from Puerto Rican economic incentive law and does not necessarily indicate that the activities described constitute substantial transformation for purposes of the foreign base company sales income rule. The trades or businesses constituting manufacturing or processing referred to in section 957(c)(2) will include, for example, the manufacture in the Commonwealth of Puerto Rico of tabulating cards, paper tablets or pads, facial tissues, and paper napkins from jumbo rolls of paper; the manufacture of such household products as liquid starch by mixing large quantities of the ingredients which are used to produce liquid starch; or the manufacture of fruit nectar juices and drinks from fruit concentrates.

Subsection (c) in effect leaves the corporations covered there subject to the rules of existing law. In order to insure that such corporations will not be availed of for tax haven activities, however, the Secretary of the Treasury or his delegate is given the power under the last sentence of section 957(c) to prescribe regulations as to whether the source of income is in the Commonwealth of Puerto Rico or a United States possession, or whether income is derived from the active conduct of a described trade or business in such Commonwealth or United States possession. However, such regulations will not change existing law governing the source of income which is derived from the "manufacture or processing" of goods, wares, merchandise or other tangible personal property in the Commonwealth of Puerto Rico.

(d) *U.S. person defined.*—Subsection (d), for which there was no corresponding provision in the House bill, provides that, for purposes of subpart F, the term "United States person" has the meaning assigned to it in section 7701(a)(30) except that—

(1) with respect to a corporation organized under the laws of Puerto Rico, such term does not include an individual who is a resident of Puerto Rico, if a dividend received by him during the taxable year from such corporation would, for purposes of section 933(1), be treated as income derived from sources within Puerto Rico,

(2) with respect to a corporation organized under the laws of the Virgin Islands, such term does not include an individual who is a resident of the Virgin Islands and whose income tax obligation under subtitle A for the taxable year is satisfied pursuant to section 28(a) of the Revised Organic Act of the Virgin Islands, approved July 22, 1954 (48 U.S.C. 1642), by paying tax on income derived from all sources into the treasury of the Virgin Islands, and

(3) with respect to a corporation organized under the laws of any other possession of the United States, such term does not include an individual who is a resident of any such other possession and whose income derived from sources within possessions of the United States is not, by reason of section 931(a), includible in gross income under subtitle A for the taxable year.

The effect of paragraphs (1), (2), and (3), above, is to exclude individuals who qualify thereunder in determining whether a foreign corporation incorporated in Puerto Rico, the Virgin Islands, or another possession of the United States, as the case may be, is a controlled foreign corporation by reason of the ownership of more than 50 percent of its stock by United States shareholders (i.e., shareholders who are

United States persons) each of whom owns 10 percent or more of the stock of such foreign corporation. This determination of whether a foreign corporation is a controlled foreign corporation is made not only for purposes of subpart F, but also for purposes of section 1248 of the code, as added by section 15 of the bill, as reported by your committee. The application of sections 931(a) and 933(1) of the code and of section 28 of the Revised Organic Act of the Virgin Islands is not affected by the bill.

SECTION 958. RULES FOR DETERMINING STOCK OWNERSHIP

Section 958 is the same as section 955 of the bill as passed by the House except for conforming and clarifying changes and the addition of certain modifications to the constructive ownership rules of section 318(a) of the Code for purposes of this section.

Section 958 provides, in subsection (a), a limited rule of stock ownership for determining the amount taxable to a United States shareholder, and, in subsection (b), a broader set of constructive rules of ownership for determining whether the requisite ownership by United States shareholders exists so as to make a corporation a controlled foreign corporation or a United States shareholder has the requisite ownership to be liable for tax under section 951(a).

(a) *In general.*—For purposes of subpart F (other than sections 955(a)(1) (A) and (B), 955(c)(2)(A)(ii), and 960(a)(1)), a United States shareholder owns the stock which he owns directly in a foreign corporation and also that which he owns through certain foreign entities as follows: stock owned, directly or indirectly, by or for a foreign corporation, foreign partnership, or a foreign trust or foreign estate (within the meaning of section 7701(a)(31)) is considered as proportionately owned by the shareholders, partners, or beneficiaries. Stock owned by such a foreign entity with the application of such rule is considered as actually owned by such foreign entity for again applying the rule. The rule in effect gives rise to a chain of ownership and, since the rule operates only on stock owned by a foreign entity, attribution under the rule stops with the first United States shareholder in the chain of ownership running from the controlled foreign corporation to such person. For example, W, a domestic corporation, owns 80 percent of the one class of stock of X, a foreign corporation, which in turn owns 80 percent of the one class of stock of Y, another foreign corporation, which in turn owns 90 percent of the one class of stock in Z. Under the rule, X is considered as owning 80 percent of the 90 percent which Y owns in Z, or 72 percent. 80 percent of such 72 percent, or 57.6 percent of the stock in Z, is considered as owned by W. Since W is a domestic corporation which is a United States shareholder, W is the person taxed even though W is wholly owned by U, another domestic corporation. If Z has $100 of subpart F income, then W is required to include $57.60 in gross income under section 951(a).

Paragraph (3) of subsection (a) provides, for the sole purpose of taxing United States shareholders on a foreign mutual insurance company's income derived from insurance of United States risks, that that term "stock" includes any certificate entitling the holder to voting power in the corporation.

(b) *Other provisions.*—Subsection (b) provides constructive rules of ownership based, with certain specified exceptions, on section 318. The principle to be followed in applying such rules is that they are to

be applied so that the effect is to subject a United States shareholder to the requirement of section 951(a), to treat a person as a related person under section 954(d)(3) with respect to a controlled foreign corporation, or to make a corporation a controlled foreign corporation under section 957.

The specified exceptions to the rules of section 318 are as follows:

(1) No attribution of ownership from a nonresident alien individual (other than a foreign estate or trust) to a citizen or resident of the United States can occur under section 318 (a)(1)(A);

(2) In considering stock owned by a partnership, estate, trust, or corporation, as owned by the partners, beneficiaries, or shareholders, a partnership, estate, trust, or corporation which owns more than 50 percent of the total combined voting power of all classes of stock entitled to vote, is to be considered as owning all the voting power of all such classes of stock;

(3) Stock of a partner, beneficiary, or shareholder which is attributed to the partnership, estate, trust, or corporation will not be attributed to another partner, beneficiary, or shareholder;

(4) In applying the rule which requires ownership of 50 percent of the stock of a corporation before stock owned by such corporation can be attributed to its stockholders, the bill as passed by the House substituted a zero limitation for the 50-percent limitation; your committee's amendment provides that a 10-percent limitation will be substituted for the 50-percent limitation in the application of clause (i) of section 318(a)(2)(C);

(5) Your committee has also added a provision that the rule that stock owned by or for a partner or a beneficiary or a shareholder of an estate or trust or corporation shall be considered as owned by the partnership, estate, or trust or corporation will not be applied so as to consider a United States person as owning stock which is owned by a person who is not a United States person, nor will a corporation be considered as owning stock owned by or for a 50 percent or more shareholder where the effect is to consider a United States person as owning stock which is owned by a person who is not a United States person.

Example (1).—M, N, and O, all United States persons, each own 20 percent of the stock in X, a foreign corporation having only one class of stock, which in turn owns 60 percent of the stock in Y, also a foreign corporation having only one class of stock. For the purpose of attributing the stock owned by X in Y to M, N, and O, X is considered as owning all of the stock of Y with the result that M, N, and O are considered as each owning 20 percent of the stock of Y.

Example (2).—A, an owner of 50 percent of the one class of stock in Y, owns 8 percent of the one class of stock in Z, a controlled foreign corporation; B (not related to A), the owner of the other 50 percent of the stock in Y, owns 45 percent of the one class of stock of Z. A is considered as owning no part of the stock in Z which is owned by B. Thus, A does not own 10 percent or more of the stock of Z so as to be required under section 951(a) to include in gross income any amount of income of Z.

Example (3).—M, N, and O, all United States persons, each own 30 percent of the stock in X, a foreign corporation having only one class of stock, which in turn owns 40 percent of the stock in Y, also a

foreign corporation having only one class of stock. Under the provisions of section 958(b)(4), M, N, and O are each considered as owning 12 percent of the stock of Y.

SECTION 959. EXCLUSION FROM GROSS INCOME OF PREVIOUSLY TAXED EARNINGS AND PROFITS

Section 959, except for conforming changes, is the same as section 956 of the bill as passed by the House.

(a) *Exclusion from gross income of United States persons.*—Subsection (a) provides that earnings and profits of a foreign corporation attributable to amounts once included in gross income under section 951(a) are not again included in gross income when actually distributed. The exclusion is applicable whether the income included in gross income under section 951 was required to be included by reason of direct ownership of stock in a controlled foreign corporation or ownership through a chain of ownership described in section 958(a). Further, the exclusion applies with respect to the United States shareholder who owned stock in a foreign corporation at the time it was included in gross income under section 951(a), or with respect to a successor in interest who can at the time of the actual distribution provide such proof as the Secretary of the Treasury or his delegate by regulations require that he holds the interest of the United States shareholder who previouslly included in gross income the earnings and profits being distributed.

Example.—On December 31, 1963, X, a United States shareholder, owns 20 shares of the 100 shares of the only class of stock in Z, a controlled foreign corporation, and by reason of such ownership includes $20 in gross income under section 951 (his proportionate share of Z's $100 of subpart F income which constituted Z's entire earnings and profits for its 1963 taxable year). On January 31, 1964, X transfers 9 shares of his stock in Z to Y. On June 1, 1964, X receives an $11, and Y a $9, distribution from Z. Neither the $11 received by X nor the $9 received by Y is includible in gross income.

Subsection (a) in conjunction with section 951(a)(1)(B) also prevents including in gross income under section 951(a)(1)(B) any increase in earnings invested in United States property to the extent such increase can be considered as attributable income taxable under section 951(a)(1)(A). Subpart F income thus provides an offset to prevent the inclusion in gross income of amounts otherwise includible as an increase in earnings invested in United States property. For example, Z, a controlled foreign corporation wholly owned by X, a domestic corporation, has $40 subpart F income, and a $50 increase in earnings invested in United States property; X includes in gross income only $10 of the $50 because $40 of such $50 is offset by the $40 of subpart F income included in X's gross income.

(b) *Exclusion from gross income of certain foreign subsidiaries.*—Subsection (b) provides that, for purposes of section 951(a), income of a controlled foreign corporation once included in gross income of a United States shareholder is not, when distributed to another controlled foreign corporation, included in any of such other foreign corporation's income which must be taxed to such United States shareholder or his successor in interest. For example, X, a domestic corporation, wholly owns Y, a controlled foreign corporation which in turn wholly owns Z, another controlled foreign corporation. In 1970,

Y has no income except that which is received from Z, which has $100 of income which X is required to include in gross income under section 951. Such $100, although paid to Y as a dividend in 1970, is not included in the income of Y which must be included in the gross income of X, even though such a dividend would ordinarily constitute subpart F income. The same result follows whether the dividend is paid in 1970 or a later year so long as under the rules of subsection (c) it is allocated to earnings and profits under paragraphs (1) and (2) which were once included in X's gross income under section 951.

(c) *Allocation of distributions.*—Subsection (c) provides rules for the allocation of distributions to earnings and profits. Amounts included in gross income of a shareholder under section 951(a) do not constitute distributions for purposes of reducing the earnings and profits of the controlled foreign corporation. Accordingly, when the controlled foreign corporation makes an actual distribution, thereby reducing its earnings and profits, it is necessary at the shareholder level to identify whether the distribution is from earnings and profits attributable to amounts already included in gross income of the shareholder under section 951(a) (in which case the distribution is not taxable as a dividend) or is from earnings and profits which are attributable to amounts not so taxed (in which case the distribution is taxable as a dividend). Under subsection (c), earnings and profits attributable to amounts once taxed (described in paragraphs (1) and (2)) are to be considered to be distributed until they are exhausted (first from the current year and next from past years). Subsequent distributions, after the earnings and profits described in paragraphs (1) and (2) have been received by a shareholder, are taxable as dividends to the extent of the remaining earnings and profits.

A shareholder is not taxable on a distribution which is out of earnings and profits described in paragraph (1) (relating to earnings invested in United States property) or paragraph (2) (relating to subpart F income). The separate classification of earnings and profits under paragraphs (1) and (2) is for purposes of computing a United States shareholder's pro rata share of the increase in earnings in United States property under section 956. For purposes of section 956(a)(2)(A), the amount of earnings invested in United States property for a taxable year is reduced by earnings so invested which were actually distributed. For this purpose, paragraph (1) of section 959(c) provides that earnings and profits attributable to investment in United States property are the first earnings and profits considered as distributed to a shareholder.

In this connection, although amounts taxed once under section 951 (a)(1)(A) may offset amounts representing an increase in earnings in United States property under section 951(a)(1)(B) (so as to avoid taxing the same earnings twice) such offset does not affect the amount of earnings and profits attributable to amounts representing the increase in earnings in United States property for purposes of paragraph (1). The amount of earnings and profits under paragraph (1) includes earnings and profits attributable to amounts includible in gross income under section 951(a)(1)(B) as well as earnings and profits attributable to amounts which would have been included under such section except for the availability of the offset by reason of the inclusion of amounts under section 951(a)(1)(A). Earnings and profits attributable to amounts included in income under section 951(a)(1)(A), but used to offset an increase in earnings invested in United States property are

not, however, included in paragraph (2) since they are already included in paragraph (1). Thus, there is no duplication in the amounts attributable to paragraphs (1) and (2), and, from the standpoint of the shareholder, the amount of earnings and profits allocable to him under paragraphs (1) and (2) is always equal to the amount of income he has been taxable on under section 951(a) (and for which he has not received an actual distribution).

Example.—M, a controlled foreign corporation, is organized on January 1, 1963, and is solely owned by X, a United States shareholder. Both M and X use the calendar year as a taxable year. M's earnings and profits for 1963 are $200, $100 of which is subpart F income. (M's income included $25 excluded under section 954(b)(1) as dividends, interest, and gains invested in qualified investments in less developed countries.) M's total United States property at the end of 1963 is $50 and M makes a distribution during 1963 of $20. The division of M's earnings and profits account at December 31, 1963, for the purpose of determining the tax on X, is as follows:

Sec. 959(c)(1) amounts ($50 increase in U.S. property less $20 distribution)	$30
Sec. 959(c)(2) amounts ($100 subpart F income less $50 used as offset to increase in investment in U.S. property and reclassified as a sec. 959(c)(1) amount)	50
Sec. 959(c)(3) amounts (the remaining earnings and profits after reduction for sec. 959(c) (1) and (2) amounts—$200 minus $20 (actual distribution) minus $30 (U.S. property) minus $50 (subpart F income))	100
Total earnings and profits at Dec. 31, 1963	180

X is required to include $100 in gross income under section 951(a)(1)(A)(i) and he would have been required to include $50 in gross income under section 951(a)(1)(B) but for section 959(a)(2) which allows the offset of previously taxed subpart F income (whether in the current year or in prior years) against increases in investments in United States property. X may exclude the $20 distribution from gross income under section 959(a)(1) since under section 959(c) such distribution is considered to be out of amounts described in section 959(c)(1).

In 1964, M's earnings and profits are $300, $75 of which is subpart F income. M has no change in investments in United States property and withdraws $15 of previously excluded subpart F income from qualified investments in less developed countries. M makes a distribution of $250 during 1964.

M's earnings and profits account, at December 31, 1964, for purposes of section 959(c) is as follows:

Sec. 959(c)(1) amounts ($30 accumulation from prior years less distributions but not in excess of total current and accumulated sec. 959(c)(1) amounts or $30)	0
Sec. 959(c)(2) amounts ($50 accumulation from prior years plus current subpart F income of $75 and withdrawals of previously excluded subpart F income from qualified investments of $15 less distributions but not in excess of total current and accumulated sec. 959(c)(2) amounts or $140)	0
Sec. 959(c)(3) amounts ($100 accumulation from prior years, plus current earnings and profits not classified under sec. 959(c) (1) or (2) of $225, less withdrawals of previously excluded subpart F income from qualified investments of $15, less distributions not out of sec. 959(c) (1) and (2) amounts of $80)	$230
Total earnings and profits at Dec. 31, 1964	230

X is required to include $75 in gross income under section 951(a)(1)(A)(i) and $15 under section 951(a)(1)(A)(ii). X may exclude $170 of the $250 distribution from gross income under the provisions of section 959(a)(1); $80 is includible in gross income as a dividend.

(d) *Distributions excluded from gross income not to be treated as dividends.*—Except for deeming foreign taxes paid by foreign corporations as being paid by a domestic corporation in special cases discussed below, a distribution excluded from gross income under section 959 is treated as a distribution which is not a dividend.

SECTION 960. SPECIAL RULES FOR FOREIGN TAX CREDIT

A domestic corporation owning stock in a controlled foreign corporation is required to include in its gross income, under the provisions of subpart F, income of such foreign corporation, whether or not the foreign corporation is one or more links removed in a chain of ownership. Therefore, section 902 (relating to credit for corporate stockholder in foreign corporation) which depends on actual distributions would not operate to give the domestic corporation a credit for foreign taxes paid by the controlled foreign corporation. Section 960 provides rules, consistent with section 902, for treating foreign taxes paid by controlled foreign corporations on income which is included in the gross income of domestic corporations under section 951(a) as having been paid by such domestic corporations. Section 960 corresponds to section 957 of the bill as passed by the House.

(a) *Taxes paid by a foreign corporation.*—Subsection (a) applies to a domestic corporation which includes in gross income under section 951(a) an amount attributable to earnings and profits of a foreign corporation at least 10 percent of the voting stock of which is directly owned by such domestic corporation, or of a foreign corporation at least 50 percent of the voting stock of which is owned by a foreign corporation at least 10 percent of the voting stock of which in turn is directly owned by the domestic corporation. If the directly owned corporation is a less developed country corporation as defined in section 902(d), then the domestic corporation is deemed to have paid the same proportion of the income, war profits, and excess profits taxes paid (or deemed paid) by the controlled foreign corporation to a foreign country or possession of the United States for the taxable year which the amount of the earnings and profits of the foreign corporation so included in gross income of the domestic corporation bears to the sum of the entire earnings and profits of such foreign corporation for such taxable year and the total amount of such income, war profits, and excess profits taxes paid by such foreign corporation.

Example 1.—X, a domestic corporation, wholly owns Y, a foreign corporation, which is a less developed country corporation, which in turn wholly owns Z, another foreign corporation. X, Y, and Z each

use the calendar year as a taxable year. For 1963, X is deemed to have paid taxes actually paid by Y and Z as follows:

	X	Y	Z
Earnings and profits plus foreign taxes		100	100
Earnings and profits		60	80
Foreign taxes		40	20
Subpart F income		30	50
Gross income under sec. 951 (30+50)	80.00		
Foreign taxes deemed paid by X under sec. 960 (a):			
$\left(\frac{30}{100}\times 40\right)$	12.00		
$\left(\frac{50}{100}\times 20\right)$	10.00		

If the directly owned corporation is not a less developed country corporation, then the domestic corporation is deemed to have paid the same proportion of the total income, war profits, and excess profits taxes paid by the controlled foreign corporation to a foreign country or possession of the United States for its taxable year which the amount of the earnings and profits of the foreign corporation included in gross income of the domestic corporation bears to the entire earnings and profits of such foreign corporation for such taxable year. The taxes so deemed paid by the domestic corporation under section 960(a)(1)(C) if the directly owned corporation is not a less developed country corporation are included in the gross income of the domestic corporation under section 78 of the code (as added by sec. 9 of the bill).

Example (2).—X, a domestic corporation, wholly owns Y, a foreign corporation not a less developed country corporation, which in turn wholly owns Z, another foreign corporation. X, Y, and Z each use the calendar year as a taxable year. For 1963, X is deemed to have paid taxes actually paid by Y and Z as follows:

	X	Y	Z
Earnings and profits		60	80
Foreign taxes		40	20
Subpart F income		30	50
Gross income under sec. 951 (30+50)	80.00		
Foreign taxes deemed paid by X under sec. 960(a)(1)(C) and included in gross income under sec. 78:			
$\left(\frac{30}{60}\times 40\right)$	20.00		
$\left(\frac{50}{80}\times 20\right)$	12.50		

If a domestic corporation receives a distribution any part of which is excluded from gross income under section 959, the foreign taxes which are deemed to have been paid under section 960(a) are not again deemed paid under section 902. Other foreign taxes which are not deemed paid under section 960 because paid, for instance, by a first-tier corporation, through which profits of a second-tier corporation are distributed (after having been taxed for a prior year under section 951 to a United States shareholder which is a corporation), will still be deemed paid under section 902 when an actual distribution is made. A distribution of such profits, although excluded under section 959(a), is treated by the domestic corporation as a dividend

solely for taking into account under section 902 such foreign taxes as were not deemed paid under section 960.

Example (3).—Suppose that the $50 of subpart F income of Z taxed to X in 1963 in examples (1) and (2) above was in 1970 distributed to Y who received no other income for such year, and that Y paid a tax of $20 for 1970 and distributed the remaining $30 to X before the end of 1970. In such case, although such $30 is excluded from gross income under section 959(a), it is treated as a dividend under section 902 so that for 1970, X is deemed to have paid $12 in foreign taxes under example (1), or $20, under example (2).

If income of a first-tier foreign corporation required to be included in the gross income of a domestic corporation under section 951(a) includes a dividend from a second-tier foreign corporation to the first-tier corporation, then section 902(b) applies to foreign taxes paid by the second-tier corporation and not already allowed as a credit in order to deem them paid by the first-tier foreign corporation so that under section 960(a) they will be deemed paid by the domestic corporation.

Example (4).—M, a domestic corporation, wholly owns N, a controlled foreign corporation, which is a less developed country corporation, which in turn wholly owns O, also a controlled foreign corporation but which has no income required to be included in any United States shareholder's gross income. For taxable year 1970, O pays $40 in foreign taxes. O pays to N as a dividend its total earnings and profits of $60 for such taxable year, which dividend is N's only income and which in N's hands is foreign base company income required to be included in M's gross income under section 951(a). N has no deductions and pays no foreign taxes. Applying section 902(b) N is deemed to have paid $24 in foreign taxes and M is in turn deemed to have paid $24 under section 960. If N were not a less developed country corporation, N and in turn M, would be deemed to have paid $40.

(b) *Special rules for foreign tax credit on receipt of previously taxed earnings and profits.*—Where a taxpayer receives a distribution which is excluded from income under section 959 because it was once taxed as income included in gross income of a United States shareholder under section 951(a), the section 904 limitation is increased in the year of actual distribution so that a credit will be allowed for foreign taxes imposed on the income distributed after it was included in gross income under section 951. The taxpayer, however, must have either chosen the foreign tax credit in the taxable year in which such income was included in gross income under section 951(a), or have paid or accrued in such year no income, war profits, or excess profits taxes to any foreign country or possession of the United States. He must also choose the foreign tax credit in the year of the receipt of the excluded distribution.

The amount of the increase in the section 904 limitation is an amount equal to the increase in such limitation which occurred in the taxable year of the inclusion of the income under section 951(a) solely by reason of such inclusion. Such amount is then reduced by the foreign taxes which were allowed as a credit in such year of the inclusion but which would not have been allowable but for such inclusion. The increase in the section 904 limitation may not exceed the income, war profits, or excess profits taxes paid, or deemed paid, or

accrued with respect to the distribution in the taxable year such distribution is received.

Under paragraph (3) of section 960(b), a taxpayer who chose to take a foreign tax credit in the taxable year in which he was required to include income in gross income under section 951(a), but does not choose to take a foreign tax credit in the taxable year in which such income is actually received, may not deduct under section 164 any income, war profits, or excess profits taxes paid or accrued on such income.

Under paragraph (4) of section 960(b), if the increase in limitation exceeds the U.S. tax for the taxable year, the excess is deemed an overpayment of tax for such year.

SECTION 961. ADJUSTMENTS TO BASIS OF STOCK IN CONTROLLED FOREIGN CORPORATION AND OF OTHER PROPERTY

Section 961 is the same as section 958 of the bill as passed by the House except for the changes made necessary by the addition of section 962, relating to an election by individuals to be subject to tax at corporate rates.

(a) *Increase in basis.*—Subsection (a) provides that the basis of a United States shareholder's stock in a controlled foreign corporation, and of property by reason of which he is treated as owning such stock in determining the amount which he must include in gross income under section 951, is increased by the amount included in gross income under section 951. Your committee has added a provision to subsection (a) that in the case of a United States shareholder who has made an election under section 962 for the taxable year, the increase in basis shall not exceed an amount equal to the amount of tax paid under chapter 1 with respect to the amounts required to be included in his gross income under section 951(a).

Example (1).—X, who owns stock in corporation M with a basis of \$1,000, includes \$50 of M's income in gross income as required under section 951(a). The basis of X's stock in M is increased to \$1,050.

Example (2).—The facts are the same as in example (1) except that X is also required under section 951(a) to include in gross income \$60 of the income of corporation N, a controlled foreign corporation wholly owned by M. In such case the basis of X's stock in M is increased to \$1,110.

Example (3).—Y, an individual United States shareholder who owns stock in corporation O with a basis of \$1,000, and who would have included \$70 in gross income under section 951(a), makes an election under section 962, and pays \$15 in U.S. tax under chapter 1 of the code. The basis of Y's stock in corporation O is increased to \$1,015.

(b) *Reduction in basis.*—Subsection (b) provides that the basis of stock or other property with respect to which a United States shareholder receives an amount which is excluded from gross income under section 959(a) is reduced by such amount. Your committee has added a provision to subsection (b) that in the case of a United States shareholder who has made an election under section 962 for any prior taxable year, the reduction in basis shall not exceed an amount equal to the

amount received which is excluded from gross income under section 959(a), relating to the exclusion of previously taxed earnings and profits, after the application of section 962(d), relating to actual distributions of earnings and profits attributable to amounts with respect to which an election was made under section 962. Thus, if X, in example (2) above, received a distribution of $110 which was excluded from gross income under section 959(a) as the income previously taxed in such example, the basis of X's stock in Y would be reduced again to $1,000. If Y, in example (3) above, received a distribution of $70, his basis in the stock of corporation O would be reduced by $15, that is, the amount excluded from gross income under section 959(a) after the application of section 962(d).

Subsection (b)(2) provides that to the extent that an amount excluded from gross income under section 959(a) exceeds the adjusted basis of stock or other property with respect to which it is received, such excess shall be treated as gain from the sale or exchange of the property.

SECTION 962. ELECTION BY INDIVIDUALS TO BE SUBJECT TO TAX AT CORPORATE RATES

Section 962 provides an election for an individual United States shareholder to be subject to tax at corporate rates instead of individual rates with respect to amounts included in his gross income under section 951(a).

(a) *General rule.*—Subsection (a) provides that in the case of a United States shareholder who is an individual and who elects to have the provisions of section 962 apply for the taxable year, the tax imposed under chapter 1 of the Code on amounts included in gross income under section 951(a), relating to amounts included in gross income of United States shareholders, shall be an amount equal to the tax which would be imposed under section 11 of the Code, relating to tax imposed on corporations, if such amounts were received by a domestic corporation. Subsection (a) further provides that, for purposes of applying the provisions of section 960, relating to foreign tax credit, the amounts included in gross income under section 951(a) with respect to which an election is made under section 962, shall be treated as if they were received by a domestic corporation.

Example.—X, an individual and sole shareholder of controlled foreign corporation M (not a less developed country corporation), is required to include $70,000 (the entire earnings and profits of M Corporation for the taxable year) in gross income under section 951(a) and makes an election under section 962 to be subject to tax at corporate rates. (M Corporation is the only controlled foreign corporation in which X is a United States shareholder.) Both X and M use the calendar year as a taxable year. M Corporation paid $30,000 of foreign tax in connection with earning the $70,000 of income referred to above. The limitation on tax under section 962(a) is equal to the

corporate tax less any foreign tax credit to which a corporation would be entitled. Thus, the tax would be computed as follows:

Income included in gross income under sec. 951(a) with respect to which election under sec. 962 is made	\$70,000
Foreign tax deemed paid under sec. 960(a) (included in gross income under new sec. 78) $\left(\frac{\$70,000}{\$70,000}\times\$30,000\right)$	30,000
Taxable income under sec. 11 of code	100,000
Tax at 52 percent	52,000
Less tax attributable to surtax exemption	5,500
Tax	46,500
Less foreign tax credit	30,000
U.S. tax liability (limitation under sec. 962(a))	16,500

(b) *Election.*—Subsection (b) provides that an election to have the provisions of section 962 apply for any taxable year shall be made by a United States shareholder at such time and in such manner as the Secretary of the Treasury or his delegate shall prescribe by regulations and that an election made for any taxable year may not be revoked except with the consent of the Secretary of the Treasury or his delegate.

(c) *Surtax exemption.*—Subsection (c) provides that, for purposes of applying subsection (a)(1), the surtax exemption provided by section 11(c) of the Code shall not exceed an amount which bears the same ratio to \$25,000 as the amounts included in a United States shareholder's gross income under section 951(a) for the taxable year bears to his pro rata share of the earnings and profits for the taxable year of all controlled foreign corporations with respect to which he included any amount in gross income under section 951(a).

Example.—X, an individual United States shareholder owning 60 percent of controlled foreign corporations N and O, makes an election under section 962 for the taxable year and includes in gross income for such year under section 951(a) \$20,000 with respect to corporation N and \$10,000 with respect to corporation O. Corporation M has \$100,000 and corporation N has \$50,000 earnings and profits for the taxable year. X's surtax exemption is computed as follows:

$$\frac{20,000+10,000}{60,000+30,000}\times 25,000=8,333.33$$

(d) *Special rules for actual distributions.*—Paragraph (1) of section 962(d) provides that the earnings and profits of a foreign corporation attributable to amounts which were included in the gross income of a United States shareholder under section 951(a) and with respect to which an election under section 962 applied shall, when such earnings and profits are distributed, notwithstanding the provisions of section 959(a)(1), relating to the exclusion from gross income of actual distributions of previously taxed earnings and profits, be included in gross income to the extent that such earnings and profits so distributed exceed the amount of tax paid on the amounts to which such election applied.

Example.—X, an individual and sole shareholder of controlled foreign corporation M (not a less developed country corporation), was required to include \$70,000 (the entire earnings and profits of M Corporation for the taxable year) in gross income under section 951(a) for the taxable year 1963, and \$30,000 (the amount of foreign taxes

paid by M Corporation for such year), and made an election under section 962 to be subject to tax at corporate rates. X paid $16,500 in U.S. tax on such amount with the application of section 962(a). In 1964, X received an actual distribution of the $35,000 from M Corporation. Notwithstanding the provisions of section 959(a)(1), X is required to include $26,750 in gorss income for the taxable year 1964 ($35,000 minus $8,250).

SECTION 963. RECEIPT OF MINIMUM DISTRIBUTIONS BY DOMESTIC CORPORATIONS

This section provides that if a given percentage, termed a minimum distribution, of the earnings and profits of a controlled foreign corporation is received by a domestic corporate shareholder of such foreign corporation, the domestic corporation may elect to exclude from its gross income for such taxable year the amount of subpart F income of such foreign corporation otherwise includible in gross income of the domestic corporation under section 951(a)(1)(A)(i). In addition to the elective treatment accorded domestic corporate shareholders with respect to subpart F income of controlled foreign corporations in which stock is owned directly, domestic corporate shareholders may elect with respect to foreign corporations in a chain of corporations or with respect to all controlled foreign corporations in which the domestic corporate shareholder owns stock directly or stock owned indirectly through interests in foreign corporations, foreign partnerships, foreign trusts or foreign estates. The required minimum distribution of earnings and profits by a foreign corporation is inversely proportional to the effective foreign tax rate of the controlled foreign corporation with respect to which an election is made, or the consolidated earnings and profits and consolidated effective foreign tax rate of a chain of foreign corporations, or a group of controlled foreign corporations, with respect to which an election is made. Thus, as the effective foreign tax rate increases, the required minimum distribution of earnings and profits decreases. The inverse proportion is intended to result in a distribution which will give rise to sufficient United States tax to make the overall taxes of the recipient roughly approximate the United States rate.

(a) *General rule.*—Subsection (a) of section 963 sets forth the general rule that subpart F income of a controlled foreign corporation will not be included in the gross income of a United States shareholder, as defined in section 951(b), if (1) the United States shareholder is a domestic corporation; (2) the domestic corporate shareholder (A) receives a minimum distribution, as defined in section 963(b), of the earnings and profits for the taxable year from a controlled foreign corporation in which stock is owned directly, within the meaning of section 958(a)(1)(A); or, (B) to the extent the domestic corporate shareholder elects, receives a minimum distribution with respect to the consolidated earnings and profits for the taxable year of foreign corporations in a chain of corporations as described in section 963(c)(2); or, (C) the domestic corporate shareholder receives a minimum distribution, as defined in section 963(b), with respect to a group of foreign corporations as described in section 963(c)(3); and (3) the domestic corporate shareholder consents to all the regulations prescribed by the Secretary of the Treasury or his delegate under section 963 prior

to the last day prescribed by section 6072 for filing its income tax return. The exclusion from gross income under this section is limited to subpart F income of controlled foreign corporations, as defined in section 952, which would otherwise be includible in gross income under section 951(a)(1)(A)(i). This section (which is concerned with current earnings and profits) does not apply to previously excluded subpart F income withdrawn from investment in less developed country corporations includible in gross income under section 951 (a)(1)(A)(ii) or increase in earnings invested in United States property includible in gross income under section 951(a)(1)(B) (both of which are measured by current and certain accumulated earnings and profits).

(b) *Minimum distributions.*—Subsection (b) of section 963 establishes a schedule of required minimum distributions of earnings and profits as a percentage of total earnings and profits. If a domestic corporate shareholder elects to apply this section to a single controlled foreign corporation as provided in subsection (a)(1), the required minimum distribution is determined by the effective foreign tax rate, determined in accordance with the provisions of subsection (d), of the controlled foreign corporation. Thus, if the controlled foreign corporation was subject to an effective foreign tax rate of 15 percent, for this elective section to apply, the controlled foreign corporation would be required to distribute, as a dividend, an amount equal to 80 percent of its earnings and profits for the taxable year of the foreign corporation ending with or within the taxable year of the electing domestic corporate shareholder. If a domestic corporate shareholder elects to apply this section to a chain of foreign corporations as provided in subsection (a)(2), the required minimum distribution is determined as a percentage of the consolidated earnings and profits of foreign corporations in the chain, to the extent elected, and the effective foreign tax rate is determined, in accordance with the provisions of subsection (d)(2), for all foreign corporations for which the election is applicable. In like manner, if a domestic corporate shareholder elects to have this section apply to all controlled foreign corporations as provided in subsection (a)(3), the required minimum distribution of earnings and profits for the taxable year is determined as a percentage of the consolidated earnings and profits of all such controlled foreign corporations, and all foreign corporations through which, within the meaning of section 958(a)(2), the domestic corporate shareholder is considered to own stock in a controlled foreign corporation, and the effective foreign tax rate is determined, in accordance with the provisions of subsection (d)(2), for all foreign corporations for which the election is applicable.

(c) *Amounts to which section applies.*—Subsection (c) of section 963 describes the controlled foreign corporation, or combination of controlled foreign corporations, in a corporate organization for which a minimum distribution of earnings and profits for a taxable year will permit a domestic corporate shareholder to elect to exclude from gross income the subpart F income of such controlled foreign corporation or corporations. Paragraphs (1), (2), (3), and (4) of section 963(c) provide for alternative applications of this section of the bill.

Paragraph (1) of section 963(c) provides that subsection (a) may apply in the case of a controlled foreign corporation in which a domestic corporate shareholder owns stock directly. Thus, application of section 963 may be limited to a single first-tier controlled

foreign corporation, to two or more first-tier controlled foreign corporations, or to all first-tier controlled foreign corporations in which a domestic corporation is a United States shareholder.

Paragraph (2) of section 963(c) provides that subsection (a) may apply to a controlled foreign corporation in which a domestic corporation owns stock directly and to a controlled foreign corporation in which the domestic corporation, within the meaning of section 958(a)(2), is considered to be the owner of stock through a foreign corporation, foreign partnership, or a foreign trust or foreign estate. However, if a domestic corporate shareholder elects with respect to a controlled foreign corporation below the first tier of foreign corporations, the earnings and profits of each foreign corporation through which the domestic corporate shareholder is considered to be the owner of stock in the controlled foreign corporation must be taken into account in determining if a required minimum distribution of consolidated earnings and profits had been made, whether or not such intermediate foreign corporations are controlled foreign corporations.

Paragraph (3) of section 963(c) provides that subsection (a) may apply to all controlled foreign corporations in which the domestic shareholder owns stock directly or is considered to own stock within the meaning of section 958(a)(2). Consistent with paragraph (2), the earnings and profits of all foreign corporations through which the domestic corporate shareholder is considered to own stock in controlled foreign corporations is taken into account in determining if a required minimum distribution had been made whether or not such intermediate foreign corporation is a controlled foreign corporation.

Subparagraph (A) of section 963(c)(4) provides for the exception of earnings and profits of certain less developed country corporations in determining if the required minimum distribution of subsection (b) has been made. The less developed country corporations which may be excluded are all such less developed country corporations other than those through which the United States shareholder is considered to own stock of other foreign corporations which are not less developed country corporations. If the election is made all less developed country corporations described in the preceding sentence must be excluded from the determination.

Subparagraph (B) of section 963(c)(4) provides that foreign branches of a domestic corporate shareholder may, at the election of such shareholder, be treated, under regulations prescribed by the Secretary of the Treasury or his delegate, as 100-percent owned controlled foreign corporations, which, for purposes of this section, will be considered to have distributed to the electing domestic corporate shareholder all of the earnings and profits attributable to such foreign branches. For purposes of this subparagraph, a branch of a domestic corporation will be considered a foreign branch if it is located in a foreign country or in the Commonwealth of Puerto Rico or a possession of the United States. However, a branch located in Puerto Rico or a possession of the United States will be taken into account under subparagraph (B) only if (1) such branch would be considered a controlled foreign corporation, if it were incorporated under the laws of Puerto Rico or such possession of the United States, as the case may be, and (2) the gross income of the electing domestic corporate shareholder, for the year of election, includes gross income derived from sources within Puerto Rico and possessions of the United States. Except as provided in the preced-

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ing sentence, an election to have subparagraph (B) apply may be made by a domestic corporation only with respect to all its foreign branches.

Generally speaking, a foreign branch is a permanent organization maintained in a foreign country to engage in the active conduct of a trade or business. The income of a branch is that produced by the business activities separately conducted by it.

Subparagraph (C) of section 963(c)(4) provides that, if a domestic corporate shareholder which is a United States shareholder so elects, the consolidated earnings and profits of controlled foreign corporations as provided in subsection (a)(3) shall not include any amount with respect to the earnings and profits of any controlled foreign corporation if it is established to the satisfaction of the Secretary of the Treasury or his delegate that the earnings and profits of such controlled foreign corporation could not have been distributed to United States shareholders who own stock, directly or through foreign corporations, foreign partnerships, or foreign estates or trusts, in such controlled foreign corporation because of currency or other restrictions or limitations imposed under the laws of any foreign country.

The application of the provisions of section 963(c) may be illustrated by the following example:

Example.—Domestic corporation M owns 5 percent of the voting stock of foreign corporation A, and 100 percent of the voting stock of foreign corporations B and C respectively. Foreign corporation C owns 100 percent of the voting stock of foreign corporation D, which owns 50 percent of the voting stock of foreign corporation E. The voting stock of foreign corporation F is owned 50 percent by foreign corporation E and 30 percent by foreign corporation B. None of the foreign corporations are less developed country corporations as defined in section 955(c). Assume that all corporations use the calendar year as a taxable year. Corporations A and E are not controlled foreign corporations.

Under section 963(a)(1), corporation M may elect to determine if a minimum distribution of earnings and profits has been made with respect to the earnings and profits of corporation B, corporation C, or both corporations B and C; and thereby exclude from gross income subpart F income of corporation B, corporation C, or both corporations B and C, as the case may be, if a minimum distribution had been received. Corporation M would be required to include in gross income its pro rata share of the subpart F income of controlled foreign corporations D and F.

In the alternative, corporation M may elect under section 963(a)(2) to consolidate the earnings and profits of corporations C and D, or corporations B, C, D, E, and F; and, if the required minimum distribution is received from corporation C with respect to the consolidated earnings and profits of corporations C and D, or from corporations B and C with respect to the consolidated earnings and profits of corporations B, C, D, E, and F, corporation M may exclude from gross income subpart F income of corporations C and D or corporations B, C, D, and F, as the case may be.

As another alternative, corporation M may elect under section 963 (a)(3) to determine if a minimum distribution of earnings and profits has been made with respect to the earnings and profits of corporations B, C, D, E, and F. If the required minimum distribution is received from corporations B and C with respect to the consolidated earnings

and profits of corporations B, C, D, E, and F, corporation M may exclude from gross income subpart F income of corporations B, C, D, and F.

(d) *Effective foreign tax rate.*—Subsection (d) of section 963 defines the term "effective foreign tax rate" as used in section 963(b).

Paragraph (1) of section 963(d) establi hes the rule for determining the effective foreign tax rate of a single controlled foreign corporation in determining if a minimum distribution has been received by a domestic corporate shareholder as required in the case of a distribution from a controlled foreign corporation to which section 963(a)(1) applies. In such a case, the effective foreign tax rate is the percentage that income, war profits, or excess profits taxes paid or accrued to foreign countries by the controlled foreign corporation on or with respect to the earnings and profits of such corporation for the taxable year of such corporation ending in or with the taxable year of the electing domestic corporate shareholder, bears to the sum of the earnings and profits of such corporation for such period and the income, war profits, and excess profits taxes paid or accrued with respect to such earnings and profits. For example, if a controlled foreign corporation had profits before foreign income taxes of $100,000, and paid foreign income taxes of $20,000, the effective tax rate would be 20 percent ($20,000/$100,000). In cases where the amount of foreign income taxes payable by the corporation varies depending upon whether or not profits are distributed by the foreign corporation, the effective foreign tax rate is determined without regard to distributions made by the controlled foreign corporation. For example, assume foreign corporation A is incorporated in country X and derives all its income from within country X. Assume also, that country X levies an income tax of 50 percent on undistributed profits and 15 percent on distributed profits. Assume further that corporation A derived before tax income of $100,000, distributed $50,000, and paid foreign income tax of $32,500 (50 percent of $50,000 undistributed income and 15 percent of $50,000 distributed income). Although corporation A only paid an effective tax rate of 32½ percent, it will be deemed to have paid an effective foreign tax rate of 50 percent for purposes of section 963. If country X had levied a tax of 25 percent on undistributed profits and an additional 15-percent withholding tax on distributed profits, although the foreign tax paid would have been the same, $32,500 or 32½ percent, the effective foreign tax rate will be deemed to be 25 percent for purposes of section 963.

Paragraph (2) of section 963(d) establishes the rule for determining the effective foreign tax rate if the earnings and profits of two or more foreign corporations are consolidated under section 963(a) (2) or (3). In such cases, the effective foreign tax rate is the percentage that income, war profits, or excess profits taxes paid or accrued to any foreign country by the foreign corporations whose earnings and profits are consolidated with respect to the total earnings and profits of such corporations for taxable years of such corporations ending in or with the taxable year of the electing domestic corporate shareholder, bears to the sum of the earnings and profits of such corporations for such periods and the income, war profits, and excess profits taxes paid or accrued with respect to such earnings and profits to any foreign country.

(e) *Special rules.*—Paragraph (1) of section 963(e) provides that distributions made by a foreign corporation in the first 60 days of any taxable year shall be treated as having been paid from the earnings and profits of the preceding taxable year or years of the foreign corporation. In addition, the Secretary of the Treasury or his delegate may by regulations provide a period in excess of 60 days in lieu of such 60-day period.

Paragraph (2) of section 963(e) permits a domestic corporate shareholder of a controlled foreign corporation who elects the provisions of this section to treat the receipt of a subsequent distribution with respect to the foreign corporation or foreign corporations to which the election applies as having been made for, and received in, the taxable year of the United States shareholder for which the domestic corporate shareholder applied the provisions of this section of the bill. For example, if a domestic shareholder received a distribution of 50 percent of the earnings and profits of controlled foreign corporation A for taxable year 1963 (the required minimum distribution of earnings and profits if the effective foreign tax rate was 40 percent), and it was determined in 1965 that the effective foreign tax rate was 30 percent, subsequent distributions equal to an additional 10 percent of 1963 earnings and profits (the required minimum distribution of earnings and profits is 60 percent if the effective foreign tax rate is 30 percent) may, if made at a time and in a manner prescribed by the Secretary of the Treasury or his delegate, be treated, for purposes of chapter 1, as having been made by the foreign corporation in taxable year 1963 and as having been received by the electing domestic corporate shareholder in its taxable year with or in which the 1963 taxable year of the controlled foreign corporation ended. The distribution will result in additional tax owing in 1963 and interest will be payable on that additional tax for the time it has been owing.

Paragraph (3) of section 963(e) provides that an affiliated group of corporations which are eligible to make a consolidated return under section 1501 for the taxable year may elect to be treated as a single United States shareholder for purposes of section 963.

The application of this provision of your committee bill may be illustrated by the following example involving domestic corporations M and N and foreign corporations A and B. Corporation A is a wholly owned subsidiary of corporation M and corporation B is a wholly owned subsidiary of corporation N. Corporation A had earnings and profits for taxable year 1963 of $100, none of which was subpart F income, after payment of foreign income tax of $120 (an effective foreign tax rate of 55 percent). Corporation B had earnings and profits for taxable year 1963 of $100, all of which was subpart F income, after payment of foreign income tax of $15 (an effective foreign tax rate of 13 percent). Corporation M received a distribution of $40 from corporation A and corporation N received a distribution of $60 from corporation B. Corporations M and N file a consolidated return with respect to income tax imposed by chapter 1. Corporations M and N elected, under the provisions of section 963(e)(3), to be treated as a single United States person for purposes of determining if a minimum distribution of the consolidated earnings and profits of corporations A and B had been received. Since the consolidated effective foreign tax rate of corporations A and B was 40 percent (the percentage that foreign tax paid ($135) bears to the sum of earnings and profits ($200), and foreign taxes paid ($135)), and corpo-

rations M and N, treated as a single shareholder, received 50 percent of the consolidated earnings and profits of corporations A and B ($100 distributed out of consolidated earnings and profits of $200), the subpart F income of corporation B is excluded from the consolidated gross income of corporations M and N.

(f) *Regulations.*—Subsection (f) of section 963 provides that the Secretary of the Treasury or his delegate shall prescribe such regulations as the Secretary of the Treasury may deem necessary to carry out the provisions of this section of the bill. Such regulations may include, among other provisions, the establishment of special rules for the determination of the amount of foreign tax credit allowable an electing domestic corporate shareholder in the case of distributions with respect to the earnings and profits of two or more foreign corporations.

Thus, special rules for the determination of the amount of foreign tax credit allowable an electing domestic corporate shareholder (including an affiliated group of corporations electing to be treated as a single U.S. shareholder) in the case of distributions with respect to the earnings and profits of a chain of foreign corporations or of brother-sister controlled foreign corporations, may be established under regulations prescribed by the Secretary of the Treasury or his delegate. The application of the provisions of this subsection may be illustrated by the following examples:

Example (1).—Assume domestic corporation M owns 100 percent of the stock of controlled foreign corporation A, which owns 100 percent of the stock of controlled foreign corporation B. All corporations use the calendar year as a taxable year. In 1963 corporation A had earnings and profits of $75 after payment of foreign income tax of $75 (a 50-percent rate). Corporation B, for taxable year 1963, had earnings and profits of $120 after payment of foreign income tax of $30 (a 20-percent rate). The consolidated effective foreign tax rate of corporations A and B was 35 percent (total tax paid over consolidated earnings and profits plus total tax paid—105/300) and required a minimum distribution of 60 percent of the consolidated earnings and profits of corporations A and B—$117 ($195×60%). Corporation M received a distribution of $117 from corporation A, which amount was includible in gross income as a dividend. Corporation M elects to consolidate under section 963(c)(2). Corporation M's tax liability under this chapter is determined as follows:

Amount includible in gross income as a dividend	$117.00
Amount included in gross income under sec. 78 (foreign tax paid with respect to $117 based upon the consolidated effective foreign tax rate of corporations A and B (117/195×105))	63.00
Total amount included in gross income	180.00
Tentative U.S. tax (at 52-percent rate)	93.60
Foreign tax credit based upon consolidated effective foreign tax rate of 35 percent (117/195×105)	63.00
Net U.S. tax	30.60

Example (2).—Domestic corporation M owns 100 percent of the stock of foreign corporations A and B. All corporations use the calendar year as a taxable year. In 1963 corporation A had earnings and profits of $80 after payment of foreign income tax of $120 (a 60-percent rate). Corporation B, for taxable year 1963, had earnings and profits of $100 with respect to which no foreign income tax had

been paid. The consolidated effective foreign tax rate of corporations A and B was 40 percent (total tax paid over consolidated earnings and profits plus total tax paid—120/300) and required a minimum distribution of $90 ($180×50 percent). Corporation M received a distribution of $80 from corporation A and $10 from corporation B, which amounts were includible in gross income as a dividend. Corporation M elects to consolidate under section 963(c)(3). Corporation M's tax liability under this chapter is determined as follows:

Amount includible in gross income as a dividend	$90
Amount included in gross income under sec. 78 (foreign tax paid with respect to $90 based upon the consolidated effective foreign tax rate of corporations A and B (90/180×120))	60
Total amount included in gross income	150
Tentative U.S. tax (at 52-percent rate)	78
Foreign tax credit based upon consolidated effective foreign tax rate of 40 percent (90/180×120)	60
Net U.S. tax	18

SECTION 964. MISCELLANEOUS PROVISIONS

Section 964 provides the regulatory authority necessary for the administration of subpart F and subpart G.

(a) *Earnings and profits.*—Under subsection (a), the earnings and profits of a foreign corporation and the deficit in earnings and profits for a taxable year shall be determined according to rules substantially similar to those applicable to domestic corporations under regulations prescribed by the Secretary of the Treasury or his delegate.

(b) *Blocked foreign income.*—Subsection (b) provides that under regulations prescribed by the Secretary of the Treasury or his delegate no part of earnings and profits shall be included in earnings and profits under sections 952, 955, and 956, if it is established to the satisfaction of the Secretary of the Treasury or his delegate that such part could not be distributed by the controlled foreign corporation to United States shareholders because of currency restrictions or limitations imposed under the laws of a foreign country. Such rule applies in either a case where the United States shareholder directly owns (see sec. 958(a)(1)(A)) the stock, or in case he indirectly owns (see sec. 958(a)(1)(B)) the stock and the restrictions apply at some point in the chain of ownership.

(c) *Records and accounts of United States shareholders.*—Subsection (c) provides that the Secretary of the Treasury or his delegate may by regulations require a United States shareholder or a person who has been a United States shareholder to maintain such records and accounts as such regulations prescribe as necessary to carry out the provisions of subpart F and subpart G. Such regulations may provide that the maintenance and furnishing of such records and accounts by one person may satisfy the requirement as to all United States shareholders otherwise required to furnish records and accounts with respect to a controlled foreign corporation.

Subpart G.—Export Trade Corporations

This subpart, for which there is no corresponding provision in the bill as passed by the House, provides generally that the export trade income, as defined in section 971(b), constituting foreign base company income of a controlled foreign corporation which is an export trade corporation, as defined in section 971(a), shall reduce the subpart F income of such corporation to the extent of such corporation's increase in investment in export trade assets, as defined in section 971(c). Limitations on this reduction are provided in section 970(a), based on the relationship of the export trade income to export promotion expenses or on the gross receipts from export trade income of the corporation. Section 970(b) provides for an inclusion in gross income of amounts by which subpart F income was previously reduced to the extent of a decrease in investment in export trade assets. Section 972 provides for the consolidation of groups of export trade corporations. Nothing in the new subpart G affects the authority of the Secretary of the Treasury or his delegate to apply the provisions of section 482 relating to allocation of income and deductions among taxpayers.

SEC. 970. REDUCTION OF SUBPART F INCOME OF EXPORT TRADE CORPORATIONS

(a) *Export trade income constituting foreign base company income.*— Subsection (a) of section 970 provides that the subpart F income of a controlled foreign corporation, as defined in section 957, which for the taxable year is an export trade corporation, as defined in section 971(a), shall be reduced by an amount equal to so much of the export trade income, as defined in section 971(b), of such corporation for such year as constitutes foreign base company income, as defined in section 954. However, the amount by which subpart F income is reduced is limited to the lesser of (1) an amount provided in subparagraph (A) of section 970(a)(1); (2) an amount provided in subparagraph (B) of section 970(a)(1); or (3) an amount provided in paragraph (2) of section 970(a). Paragraph (1) of section 970(a) also provides that subpart F income of a controlled foreign corporation is to be determined without regard to subpart G. Thus, the amount of foreign base company income of a controlled foreign corporation, for purposes of section 954(b)(3), is determined without regard to the amount by which subpart F income is reduced under section 970.

Subparagraph (A) of section 970 provides that the amount by which subpart F income may be reduced under section 970 may not exceed an amount equal to 1½ times so much of the export promotion expenses, as defined in section 971(d), of the export trade corporation for the year as is properly allocable to the export trade income of such corporation which constitutes foreign base company income for such year.

Subparagraph (B) of section 970(a)(1) provides, as an alternative limitation, that the amount by which subpart F income may be reduced under section 970 may not exceed an amount equal to 10 percent of so much of the gross receipts for the taxable year accruing to the export trade corporation from the sale, installation, operation, maintenance, or use of property in respect of which the export trade corporation derived export trade income which is properly allocable

to export trade income which constituted foreign base company income for such year. If the gross receipts attributable to the sale, installation, operation, maintenance, or use of export property arises from commissions, fees, or other compensation received by an export trade corporation for its services, the amount upon which the 10-percent limitation applies is the amount upon which the commission, fee, or other compensation is computed.

The allocations with respect to export trade income which constitute foreign base company income under subparagraphs (A) and (B) shall be made under regulations prescribed by the Secretary of the Treasury or his delegate.

In addition to the alternative limitations provided in paragraph (1) of section 970(a), paragraph (2) of section 970(a) establishes an overall limitation that provides that the reduction under paragraph (1) for any taxable year shall not exceed an amount which bears the same ratio to the increase in the investments in export trade assets of an export trade corporation for its taxable year as the export trade income which constitutes foreign base company income of the export trade corporation for the taxable year bears to the entire export trade income of such corporation for such year.

The application of the provisions of this subsection may be illustrated by the following examples:

Example (1).—Corporation A, a 100-percent owned subsidiary of domestic corporation M, purchased products manufactured by corporation M in the United States from corporation M and resold such products to unrelated persons for use outside the foreign country in which corporation A was incorporated. For taxable year 1963, the entire operations of corporation A consisted of this activity. In such year, it purchased goods from corporation M for $1,000 and sold the goods for $2,000. Corporation A derived gross income of $1,000, incurred export promotion expenses of $300 with respect to such sales, paid foreign income taxes of $50, and derived export trade income of $650, all of which constituted foreign base company income. Corporation A, in 1963, had an increase in investment in export trade assets of $100. The limitation on the amount by which subpart F income is reduced with respect to export trade income which constitutes foreign base company income as provided in section 970(a), is $100, the lesser of (1) the export trade income which constitutes foreign base company income ($650); (2) 1½ times the export promotion expenses properly allocable to export trade income which constitutes foreign base company income ($450 (150 percent of $300)); (3) 10 percent of gross receipts from the sale of property from which corporation A derived export trade income which is properly allocable to export trade income which constitutes foreign base company income ($200 (10 percent of $2,000)); or (4) the increase in investment in export trade assets ($100). Corporation M would include $550 of subpart F income of corporation A in gross income in accordance with the provisions of section 951(a)(1)(A)(i).

Example (2).—Controlled foreign corporation A, a 100-percent owned subsidiary of domestic corporation M, in taxable year 1965 had net income of $100 and qualified as an export trade corporation. Corporation A derived export trade income of $75, of which $60 was foreign base company income. The remaining $25 of net income, which was not export trade income, was subpart F income. The

$60 of export trade income which constituted foreign base company income was less than 1½ times the export promotion expenses of $100 of corporation A for the taxable year properly allocable to such income and less than 10 percent of gross receipts of $1,000 from the sale, installation, operation, maintenance, or use of property in respect of which corporation A derived export trade income which constituted foreign base company income. The total increase in investment in export trade assets was $40. Corporation M is required to include $53 subpart F income of corporation A in gross income for taxable year 1963, which amount is computed as follows:

(i) Tentative subpart F income of corporation A ($60 which is also export trade income plus $25 which is not export trade income)		$85
(ii) Amount by which subpart F income is reduced under sec. 970(a):		
(*a*) Export trade income which reduces subpart F income before application of the sec. 970(a)(2) limitation (item (1), (2), or (3), whichever is the lesser):		
(1) Export trade income which is foreign base company income	$60	
(2) 150 percent of export promotion expenses properly allocable to the amount described in (1) (sec. 970(a)(1)(A))	150	
(3) 10 percent of gross receipts from the sale of property from which the amount described in (1) was derived (sec. 970(a)(2)(B))	100	
(*b*) Section 970(a)(2) limitation: The percentage of the increase in investment in export trade assets which export trade income which constitutes foreign base company income bears to total export trade income $\$40 \times \frac{\$60}{\$75} =$	32	
Amount of export trade income which reduces subpart F income (item (a) or (b) whichever is lesser)		32
(iii) Subpart F income includible in gross income of corporation M (item (i) minus item (ii))		53

(b) *Inclusion of certain previously excluded amounts.*—Subsection (b) of section 970 provides that each United States shareholder, as defined in section 951(b), who is a shareholder in a controlled foreign corporation that was an export trade corporation in any prior taxable year, must include in his gross income, under section 951(a)(1)(A)(ii), as an amount to which section 955 applies, an amount equal to his pro rata share of the decrease in investments in export trade assets of the controlled foreign corporation for such year. The United States shareholder's pro rata share of a decrease is includible in gross income under section 970(b), however, only to the extent of—

(1) the excess of the United States shareholder's pro rata share of the sum of the reductions for all previous years in subpart F income by reason of section 970(a) and section 972 (relating to the treatment of two or more corporations as a single corporation), over

(2) all inclusions in his gross income under section 951(a)(1)(A)(ii) with the application of section 970(b) for all previous years.

Example.—Assume that for 1963 Z, a controlled foreign corporation, having $100 in export trade income of which $40 is subpart F income, has an increase in investment in export trade assets of $100 and reduces its subpart F income by $40 under section 970(a) (with the application of the sec. 970(a)(2) overall limitation which is also $40).

Assume that for 1964 Z has a $50 decrease in investment in export trade assets. Y, a United States shareholder, who wholly owns Z, must include $40 in gross income under subsection (b) as his pro rata share of the decrease in investments in export trade assets.

(c) *Investments in export trade assets.*—Subsection (c) of section 970 establishes the rules for determining if, for a taxable year of a controlled foreign corporation, there has been an increase in investments in export trade assets for purposes of section 970(a), or a decrease in investments in export trade assets for purposes of section 970(b).

Paragraph (1) of section 970(c) provides that the amount taken into account with respect to any export trade asset will be its adjusted basis, reduced by any liability to which the asset is subject.

Paragraph (2) of section 970(c) provides that the amount of increase in investments in export trade assets of a controlled foreign corporation for any taxable year, for purposes of section 970(a), is the amount by which the amount of such investments at the close of the taxable year exceeds the amount of such investments at the close of the preceding taxable year.

Paragraph (3) of section 970(c) provides that the amount of decrease in investments in export trade assets of a controlled foreign corporation for any taxable year, for purposes of section 970(b), is the amount by which the amount of such investments at the close of the preceding taxable year, reduced by an amount equal to the amount of the net loss sustained during the taxable year with respect to export trade assets, exceeds the amount of such investments at the close of the taxable year.

Paragraph (4) of section 970(c) provides that a United States shareholder of an export trade corporation may, under regulations prescribed by the Secretary of the Treasury or his delegate, make the determinations under paragraphs (2) and (3) of section 970(c) as of the close of the 75th day after the close of the years referred to in such paragraphs in lieu of on the last day of such years. It is also provided that such an election made for any taxable year shall apply to such year and to all succeeding taxable years unless the Secretary of the Treasury or his delegate consents to the revocation of such election.

SECTION 971. DEFINITIONS

Section 971 defines the terms export trade corporation, export trade income, export trade assets, export promotion expenses, export property, and unrelated person for purposes of subpart G of subchapter N of chapter 1.

(a) *Export trade corporation.*—Subsection (a) of section 971 defines the term "export trade corporation" for purposes of subpart G.

Paragraph (1) of section 971(a) establishes the general rule that a controlled foreign corporation, as defined in section 957, is an export trade corporation if for the three calendar year period immediately preceding the close of the taxable year of such corporation, the corporation (1) derived 90 percent or more of its gross income from sources without the United States, as determined in accordance with the provisions of sections 861 through 863, and (2) 75 percent or more of the gross income of such corporation constituted income in respect of which the controlled foreign corporation derived export trade income, as defined in section 971(b). However, for taxable years of a controlled foreign corporation ending less than three calendar years after

taxable years of such corporation beginning after December 31, 1962, 90 percent or more of the gross income of such corporation must be derived from sources without the United States, and 75 percent or more of the gross income of such corporation must have constituted income in respect of which the controlled foreign corporation derived export trade income, for taxable years of the corporation beginning after December 31, 1962.

Paragraph (2) of section 971(a) provides a special rule in the case of controlled foreign corporations if 50 percent or more of the gross income of such a corporation, for the period specified in section 971(a)(1)(A), constituted income in respect of which the controlled foreign corporation derived export trade income in respect of agricultural products grown in the United States. In such cases, a controlled foreign corporation is considered an export trade corporation without regard to the fact 75 percent or more of the gross income of such corporation does not constitute income in respect of which the controlled foreign corporation derived export trade income.

(b) *Export trade income.*—Subsection (b) of section 971 defines the term "export trade income" for purposes of subpart G.

Paragraph (1) of section 971(b) includes within the definition of export trade income, net income of a controlled foreign corporation derived from the sale of export property, as defined in section 971(e), by the controlled foreign corporation to an unrelated person, as defined in section 971(f), for use, consumption, or disposition outside the United States. The export trade income derived from the sale of export property may consist of other than foreign base company sales income, as defined in section 954(d). For example, goods may be purchased by the export trade corporation from an unrelated person and sold to an unrelated person, or if purchased from a related person, the goods may be sold to an unrelated person for use, consumption, or disposition within the country in which the export trade corporation is incorporated. In addition to net income derived from the purchase and resale of property manufactured, produced, grown, or extracted in the United States, export trade income includes net income from commissions, fees, compensation, or other income of a controlled foreign corporation (1) derived from the performance of commercial, industrial, financial, technical, scientific, managerial, engineering, architectural, skilled, or other services in connection with the sale of export property to an unrelated person for use, consumption, or disposition outside the United States or (2) derived in connection with the installation or maintenance of such property.

Paragraph (2) of section 971(b) includes within the definition of export trade income, net income of a controlled foreign corporation derived from commercial, industrial, financial, technical, scientific, managerial, engineering, architectural, skilled, or other services performed by the controlled foreign corporation in connection with the use by an unrelated person outside the United States of patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property acquired or developed and owned by the United States manufacturer, producer, grower, or extractor of export property, but only if the controlled foreign corporation derived export trade income (as defined in sec. 971(b)(1)) from the sale of such property.

Paragraph (3) of section 971(b) includes within the definition of export trade income, net income of a controlled foreign corporation

derived from the furnishing of technical, scientific, or engineering services to unrelated persons to the extent income from such services is attributable to the use of export property in the rendition of the services. If income from the rendition of technical, scientific, or engineering services is not solely attributable to the use of export property, and the amount attributable to export property cannot be established by reference to transactions between unrelated persons, the amount of export trade income will be deemed to be that percentage of total gross income received by the controlled foreign corporation from such services as the cost of the export property consumed in the rendition of such services, including a reasonable allowance for depreciation, bears to the total cost attributable to such service income. For example, assume a machine produced in the United States was sold to a customer in Germany. Controlled foreign corporation A contracted to furnish technical services to the German user with respect to the United States manufactured machine and a similar machine manufactured in Germany. The entire commission allocable to servicing the United States manufactured machine would be export trade income. If corporation A used replacement parts manufactured in the United States in servicing the German manufactured machine, corporation A would derive export trade income in the percentage of the commission allocable to servicing the German machine as the cost of the United States replacement parts used in furnishing the service bears to total cost and expenses of furnishing the services.

Paragraph (4) of section 971(b) includes within the definition of export trade income, interest income received by a controlled foreign corporation on evidences of indebtedness executed by unrelated persons in connection with payment for purchases of export property for use, consumption, or disposition outside the United States, or in connection with the payment for services described in sections 971(b) (2) and (3).

(c) *Export trade assets.*—Subsection (c) of section 971 defines the term "export trade assets" for purposes of subpart G to include (1) working capital reasonably necessary for the production of export trade income; (2) inventory of export property held for use, consumption, or disposition outside the United States; (3) facilities located outside the United States for the storage, handling, transportation, packaging, or servicing of export property; and (4) evidences of indebtedness executed by unrelated persons in connection with payment for purchases of export property for use, consumption, or disposition outside the United States, or in connection with services described in section 971(b) (2) and (3). For purposes of paragraph (2) of section 971(c), inventory of an export trade corporation will constitute export property held for use, consumption, or disposition outside the United States, even if such property is in the United States pending shipment. For purposes of paragraph (3) of section 971(c) a facility used for the manufacture or production of property will not be considered to be used for the purpose of handling export property, even though export property may be used or consumed in production or become a component part of a manufactured article.

(d) *Export promotion expenses.*—Subsection (d) of section 971 defines the term "export promotion expenses," as used in section 970(a)(1), to include all ordinary and necessary expenses paid or in-

curred by a controlled foreign corporation which are reasonably allocable to the receipt or production of export trade income. Expenses so allocable include, but are not limited to, a reasonable allowance for salaries or other compensation for personal services actually rendered for the purpose of producing export trade income, rentals or other payments for the use of property actually used for the purpose of producing export trade income, and a reasonable allowance for the exhaustion, wear, and tear of property actually used for the purpose of producing export trade income. However, no expense incurred within the United States will be treated as an export promotion expense unless at least 90 percent of all salaries incurred for the production of export trade income, 90 percent of rents and other payments for the use of property used for producing export trade income, 90 percent of depreciation allowances on property used in the production of export trade income, and 90 percent of all other ordinary and necessary expenses reasonably allocable to the production of export trade income, are paid or incurred outside the United States. For this purpose, salary expenses will be considered paid or incurred at the place where the employment is performed, and rents, depreciation and other expenses related to property will be considered incurred at the place where the property is located.

(e) *Export property.*—Subsection (e) of section 971 defines the term "export property" for purposes of subpart G to include any property manufactured, produced, grown, or extracted in the United States, or any interest in such property.

(f) *Unrelated person.*—Subsection (f) of section 971 defines the term "unrelated person" for purposes of subpart G to mean a person other than a related person as defined in section 954(d)(3).

SEC. 972. CONSOLIDATION OF GROUP OF EXPORT TRADE CORPORATIONS

Section 972 provides that a United States shareholder, as defined in section 951(b), of a controlled foreign corporation which is an export trade corporation, may, under regulations prescribed by the Secretary of the Treasury or his delegate, treat as a single controlled foreign corporation, for purposes of subparts F and G of subchapter N, (1) such controlled foreign corporation, (2) all controlled foreign corporations which are export trade corporations if 80 percent or more of the total combined voting power of all classes of stock entitled to vote of which is owned by such controlled foreign corporation, and (3) all controlled foreign corporations which are export trade corporations if 80 percent or more of the total combined voting power of all classes of stock entitled to vote of which is owned by controlled foreign corporations described in item (2).

(b) *Technical and clerical amendments.*—Subsection (b) of section 12 of the bill makes conforming changes.

(c) *Effective date.*—Subsection (c) of section 12 of the bill provides that the amendments made by section 12 are to apply with respect to taxable years of foreign corporations beginning after December 31, 1962, and to taxable years of United States shareholders in which or with which such taxable years of such corporations end.

SECTION 13. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE PROPERTY

(a) *In general.*—Paragraph (1) of section 13(a) of the bill adds a new section 1245 to the 1954 Code. In general, the new section provides for the inclusion in gross income (as ordinary income) of the gain from the disposition of certain depreciable property, to the extent of depreciation deductions taken in periods after December 31, 1961, which are reflected in the adjusted basis of such property.

SECTION 1245. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE PROPERTY

(a) *General rule.*—Paragraph (1) of section 1245(a) provides the general rule that if "section 1245 property" is disposed of, the amount by which the lower of "recomputed basis" or the amount realized (or the fair market value in transactions in which no amount is realized) exceeds the adjusted basis of the property is to be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231. The term "disposed of" includes any transfer or involuntary conversion. The bill as passed by the House provided that paragraph (1) applies only to dispositions after the enactment of the Revenue Act of 1962. The bill as reported by your committee provides that paragraph (1) applies only to dispositions during taxable years beginning after December 31, 1962.

Paragraph (2) of section 1245(a), under the bill as passed by the House, defined "recomputed basis" as the adjusted basis of the property recomputed by adding thereto all adjustments, for taxable years beginning after December 31, 1961, reflected in such adjusted basis on account of deductions for depreciation, or for amortization under section 168, whether in respect of the same or other property and whether allowed or allowable to the taxpayer or any other person. Your committee amendments provide that such adjustments shall be added thereto for all periods after December 31, 1961. For example, if a taxpayer, who reports his income on the basis of a fiscal year ending November 30, purchases section 1245 property on January 1, 1962, at a cost of $10,000 and the taxpayer takes depreciation deductions of $2,000 (the amount allowable) before making a gift of the property to his son on October 31, 1962, the son's adjusted basis in the property for purposes of determining gain would, under the provisions of sections 1015 (relating to the basis of property acquired by gift) and 1016 (relating to adjustments to basis), be the same as his father's adjusted basis ($8,000), and the recomputed basis of the property in the son's hands would be $10,000 since the $2,000 of depreciation deductions taken by the father are reflected in the son's basis in the property. Thus, if the son later sells the property, during a taxable year of the son beginning after December 31, 1962, for $10,000, he would have $2,000 of gain to which section 1245(a) applies. Moreover, if the son himself takes $1,000 in depreciation deductions (the amount allowable) with respect to the property and then sells it for $10,000, he would have $3,000 of gain to which section 1245(a) applies.

While recomputed basis is determined with respect to adjustments to basis for deductions for depreciation (and for amortization under sec. 168) which were either allowed or allowable, if the taxpayer can

establish by adequate records or other sufficient evidence that the amount allowed for any taxable year was less than the amount allowable, the amount to be added for such taxable year is the amount allowed. For example, assume that in the year 1967 it becomes necessary to determine the recomputed basis of property, the adjusted basis of which reflects an adjustment of $1,000 with respect to depreciation deductions allowable for the calendar year 1962. If the taxpayer can establish by adequate records or other sufficient evidence that he had been allowed a deduction of only $800 for 1962, then in determining the recomputed basis, the amount added to adjusted basis with respect to the $1,000 adjustment to basis for 1962 will be only $800.

Paragraph (1) of section 1245(a) further provides that gain is to be recognized notwithstanding any other provision of subtitle A of the 1954 Code. Thus, other nonrecognition sections of the code are overridden by the new section. For example, the gain under such paragraph (1) would be recognized to a corporation in the case of a distribution of section 1245 property by it to a shareholder, notwithstanding the provisions of section 311(a) or 336. Likewise, gain under such paragraph (1) would be recognized to a corporation on a sale or exchange of such property, notwithstanding the provisions of section 337. The operation of section 1245 may, however, be affected by the taxpayer's method of accounting. For example, the gain from a disposition to which section 1245 applies may be reported by the taxpayer under the installment method if such method is otherwise available under section 453 of the code. For another example, section 1245 does not require recognition of gain or loss upon normal retirement of an asset in a multiple asset account as long as the taxpayer's method of accounting, in accordance with Treasury regulations, does not require recognition of such gain or loss and clearly reflects income.

In the case of a disposition of section 1245 property in which an amount is realized (a sale, exchange, or involuntary conversion), the gain to which section 1245(a) applies is the amount by which the amount realized or the recomputed basis, whichever is lower, exceeds the adjusted basis of the property. In the case of any other disposition, the gain to which section 1245(a) applies is the amount by which the fair market value of the property on the date of disposition or its recomputed basis, whichever is lower, exceeds its adjusted basis. For example, if section 1245 property has an adjusted basis of $2,000 and a recomputed basis of $3,300 and is sold for $2,900, the gain to which section 1245(a) applies is $900 ($2,900 minus $2,000). If the property is sold for $3,700, the gain is $1,700, of which $1,300 ($3,300 minus $2,000) is gain to which section 1245(a) applies. If, on the other hand, the property is distributed by a corporation to a stockholder in a distribution to which section 1245(a) applies and at a time when the fair market value of the property is $3,100, the gain recognized to the corporation upon such disposition is $1,100 ($3,100 minus $2,000); if the fair market value is $3,800 at the time of such disposition, the gain to which section 1245(a) applies is $1,300 ($3,300 minus $2,000).

Paragraph (3) of section 1245(a) defines "section 1245 property." Section 1245 property is any property (other than livestock) of a type described in subparagraph (A) or (B) of such paragraph (3) which is or has been property of a character subject to the allowance for de-

preciation provided in section 167. Even though the property may not be subject to the allowance for depreciation in the hands of the taxpayer, such property is nevertheless subject to the provisions of section 1245(a) if the property was subject to the allowance for depreciation in the hands of any prior holder, and if such depreciation is taken into account in determining the adjusted basis of the property in the hands of the taxpayer.

The definition of "section 1245 property" is similar in certain respects to the definition of "section 38 property" contained in section 48(a) (relating to the investment credit). However, section 1245 property is a broader concept than section 38 property, since (for example) the definition of section 1245 property is not subject to the minimum useful life provision in section 48(a)(1) or to the other limitation and exclusion provisions in paragraphs (2) through (5) of section 48(a). Moreover, the term "personal property" in subparagraph (A) of section 1245(a)(3) is intended to include not only "tangible personal property" referred to in section 48(a)(1)(A) but also intangible personal property.

Subparagraph (B) of section 1245(a)(3) describes other property (not including a building or its structural components) if such other property is tangible and has an adjusted basis in which there are reflected adjustments for depreciation or amortization under section 168 which would be taken into account in determining recomputed basis for a period in which such property (or other property) either (i) was used as an integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or (ii) constituted research or storage facilities used in connection with any such activities. The language in clauses (i) and (ii) in section 1245(a)(3)(B) is intended to have the same meaning as when used in clauses (i) and (ii) in section 48(a)(1)(B) (relating to the definition of sec. 38 property subject to the investment credit). Even though the property is not used by the taxpayer as an integral part of an activity specified in clause (i), or does not constitute research or storage facilities within the meaning of clause (ii), such property in certain circumstances may, nevertheless, be section 1245 property under subparagraph (B). An illustration of such a circumstance is when the adjusted basis of such property in the hands of the taxpayer reflects adjustments for depreciation with respect to such property taken for periods after December 31, 1961, at a time when such property was used as an integral part of manufacturing by the taxpayer or another taxpayer. Another illustration is when the adjusted basis of such property in the hands of the taxpayer reflects adjustments for depreciation with respect to *other* property (as, for example, in the case of a like kind exchange under sec. 1031) taken for periods after December 31, 1961, at a time when such other property was used as an integral part of manufacturing by the taxpayer.

(b) *Exceptions and limitations.*—Subsection (b) of section 1245 sets forth certain exceptions and limitations to the general rule provided in subsection (a). Paragraph (1) provides that subsection (a) will not apply to a disposition by gift. Paragraph (2) provides that, except as provided in section 691, subsection (a) will not apply to a transfer at death.

Paragraph (3) of section 1245(b) provides that if the basis of property in the hands of a transferee is determined by reference to its basis

in the hands of the transferor by reason of the application of certain sections of the code providing for nonrecognition treatment, then the amount of gain taken into account by the transferor under subsection (a)(1) is to be limited to the amount of gain recognized by the transferor under these sections (determined without regard to sec. 1245). These nonrecognition provisions are: Section 332 (relating to distributions in liquidation of an 80 percent or more controlled subsidiary corporation); section 351 (relating to transfers to a corporation controlled by the transferor); section 361 (relating to exchanges pursuant to certain corporate reorganizations); section 371(a) (relating to exchanges pursuant to certain receivership and bankruptcy proceedings); section 374(a) (relating to exchanges pursuant to certain railroad reorganizations); section 721 (relating to transfers to a partnership in exchange for a partnership interest); and section 731 (relating to distributions by a partnership to a partner). For example, assume that a taxpayer transfers section 1245 property to a corporation in exchange for cash of $1,000, and stock in the corporation worth $9,000, in a transaction qualifying under section 351. The property has a fair market value of $10,000, a recomputed basis of $8,000, and an adjusted basis of $4,000. Since under section 351(b) gain in the amount of $1,000 would be recognized to the transferor without regard to the new section 1245, subsection (b)(3) limits the gain taken into account by the transferor under section 1245(a) to $1,000. The basis of the property in the hands of the corporation under section 362(a) (relating to basis to corporations of property acquired by issuance of stock, etc.) will be $5,000, that is, the adjusted basis of the property in the hands of the transferor ($4,000) increased by the gain recognized to the transferor on the transfer ($1,000). If the corporation later sells the property for $10,000 without having taken any deductions with respect to the property, the gain recognized to the corporation under subsection (a) will be $3,000, the excess of recomputed basis ($8,000) over adjusted basis ($5,000).

Since the limitation provided in subsection (b)(3) upon the gain recognized under subsection (a) is confined to instances of "carryover basis," in the case of the liquidation of an 80 percent or more controlled subsidiary the limitation is not applicable if the basis of the property in the hands of the parent corporation is determined under section 334(b)(2). Subsection (b)(3) does not apply to a disposition of property to an organization (other than a cooperative described in sec. 521) exempt from taxation under chapter 1 of the code, but no implication is intended as to whether a transfer to such an exempt organization could or could not qualify for nonrecognition under the sections of the code set forth in subsection (b)(3).

Paragraph (4) of section 1245(b) provides that if property is disposed of and gain (determined without regard to sec. 1245) is not recognized in whole or in part under section 1031 (relating to like kind exchanges) or 1033 (relating to involuntary conversions), then the amount of gain taken into account under section 1245(a) is not to exceed the sum of the amount of gain recognized on such disposition (determined without regard to sec. 1245) plus the fair market value of property acquired which is not section 1245 property and which is not otherwise taken into account in determining the gain under section 1031 or 1033. For example, assume that a taxpayer owns section1245 property with an adjusted basis of $100,000 and a recomputed basis of

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$116,000. The property is destroyed by fire and the taxpayer receives $117,000 of insurance proceeds. He uses $105,000 of the proceeds to purchase property similar or related in service or use to the property destroyed in an acquisition qualifying under section 1033(a)(3)(A), and he uses $9,000 of the proceeds to purchase stock in the acquisition of control of a corporation owning property similar or related in service or use to the converted property, which acquisition also qualifies under section 1033(a)(3)(A). The taxpayer properly elects under section 1033(a)(3)(A) and the regulations thereunder to limit recognition of gain to the amount by which the amount realized from the conversion exceeds the cost of the stock and other property acquired to replace the converted property. Since $3,000 of the gain is recognized (without regard to sec. 1245) under section 1033(a)(3) (that is, $117,000 minus $114,000), and since the stock purchased for $9,000 is not depreciable property and was not taken into account in determining the gain under section 1033, the amount of gain to be taken into account under section 1245(a) may not exceed $12,000. Thus, section 1245(a) applies to $12,000 of the $16,000 gain.

Paragraph (5) of section 1245(b) empowers the Secretary of the Treasury or his delegate to prescribe regulations setting forth rules consistent with paragraphs (3) and (4) in the case of transactions described in section 1071 (relating to gain from sale or exchange to effectuate policies of FCC) or section 1081 (relating to nonrecognition of gain or loss on exchanges or distributions in obedience to orders of SEC).

Paragraph (6)(A) provides that, for purposes of section 1245, the basis of section 1245 property distributed by a partnership to a partner will be deemed to be determined by reference to the adjusted basis of such property to the partnership. Paragraph (6)(B) provides that, for purposes of computing the recomputed basis of such property, the amount of the adjustments added back for periods before the distribution is the amount of gain to which section 1245(a) would have applied if such property had been sold by the partnership immediately before the distribution, reduced by the amount of such gain which resulted from the application of section 751(b). Thus, since the basis of section 1245 property distributed by a partnership to a partner is deemed to be a carryover basis, any subsequent disposition of the property which requires a computation of the recomputed basis would have to take into account adjustments to basis for depreciation deductions taken before the distribution. However, such adjustments are fixed at an amount equal to the gain to which section 1245(a) would have applied if the partnership had sold the property instead of distributing it, assuming no gain upon distribution arose out of the application of section 751(b).

The application of this provision is illustrated as follows: A, B, and C are equal partners in a partnership whose assets consist of three pieces of section 1245 property, assets X, Y, and Z, each with a fair market value of $100,000. Asset X has an adjusted basis of $60,000 and a recomputed basis of $85,000; asset Y has an adjusted basis of $85,000 and a recomputed basis of $110,000; and asset Z has an adjusted basis of $95,000 and a recomputed basis of $100,000. Asset Y is distributed to B in complete liquidation of his partnership interest. B's basis in his partnership interest is $75,000, and under section 732 this basis is allocated to asset Y. If B later sells asset Y for $103,000 at a time when the adjusted basis is still $75,000 and

if B has not taken any depreciation deductions with respect to asset Y since the distribution, the gain to which section 1245(a) applies would be $15,000, since the recomputed basis of the property is only $90,000, that is, the adjusted basis of the property ($75,000) increased by the amount of gain ($15,000) which would have been recognized to the partnership if the asset had been sold for its fair market value at the time of distribution ($100,000 minus $85,000).

(c) *Adjustments to basis.*—Subsection (c) of section 1245 provides that the Secretary of the Treasury or his delegate is to prescribe such regulations as he may deem necessary to provide for adjustments to the basis of property to reflect gain to which section 1245(a) applies. This provision is necessary to prevent the same amount from being subjected to taxation more than once. For example, under existing law if a corporation distributes section 1245 property to a corporate shareholder, generally the amount of the distribution and the basis of the property in the hands of the corporate distributee is the fair market value of the property or its adjusted basis in the hands of the distributing corporation, whichever is lower. Under section 1245, however, the distribution may result in gain being recognized to the distributing corporation and unless the distributee is permitted to increase its carryover basis by the amount of the gain recognized to the distributor, the same gain may be subjected to tax when the distributee later sells the property. Therefore, under regulations prescribed by the Secretary of the Treasury or his delegate, adjustment will be made to the basis of the distributed property to reflect the gain recognized to the distributing corporation.

(d) *Application of section.*—Subsection (d) of section 1245 provides that the section is to apply notwithstanding any other provision of subtitle A of the code. Thus, section 1245 overrides any nonrecognition provision of subtitle A or any "income characterizing" provision. For example, the gain to which section 1245(a) applies might otherwise be considered as gain from the sale or exchange of a capital asset under section 1231 (relating to property used in the trade or business and involuntary conversions). Since section 1245 overrides section 1231, the gain to which section 1245(a) applies will be treated as ordinary income, and only the remaining gain, if any, from the property may be considered as gain from the sale or exchange of a capital asset if section 1231 is applicable. For example, assume that a taxpayer sells for $130 section 1245 property with an adjusted basis of $40 and a recomputed basis of $100. The excess of the recomputed basis over adjusted basis, or $60, will be treated as gain under section 1245(a). The excess of the selling price over recomputed basis, or $30, may be considered under section 1231 as gain from the sale of a capital asset.

Subsection (d) is not intended to prevent gain not recognized under section 1245 from being considered as gain under another provision of the code. For example, assume that a taxpayer purchases section 1245 property for $1,000 and for periods before December 31, 1961, he takes deductions of $500 under section 168 (relating to amortization of emergency facilities). Assume that if section 168 had not applied the taxpayer would instead have taken depreciation deductions of $300. For periods after December 31, 1961, the taxpayer takes additional deductions under section 168 of $400. Under these facts, if the property is then sold for $800, section 1245(a) would recognize gain to the extent of the $400 in deductions taken in periods after

December 31, 1961, but would not recognize gain to the extent of the deductions taken in prior periods. Nothing in subsection (d) prevents \$200 of the remaining gain from being taxed under section 1238 (relating to amortization in excess of depreciation).

SECTION 13. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE PROPERTY (Continued)

(b) *Change in method of depreciation.*—Subsection (b) of section 13 of the bill amends subsection (e) of section 167 of the 1954 Code (relating to depreciation). Paragraph (1) of section 167(e) is the same in substance as existing section 167(e). Under paragraph (2), which is new, the bill as passed by the House provided that any taxpayer may, within such period after the date of the enactment of the Revenue Act of 1962 and in such manner as the Secretary of the Treasury or his delegate shall by regulations prescribe, elect to change his method of depreciation in respect of section 1245 property from any declining balance or sum of the years-digits method to the straight-line method. Your committee's amendment provides that the taxpayer may make the election with respect to taxable years beginning after December 31, 1962, on or before the last day prescribed by law (including extensions thereof) for filing his return for such first taxable year.

(c) *Salvage value of personal property.*—Subsection (c)(1) of section 13 of the bill adds a new subsection (f) to section 167 of the code (relating to depreciation) and redesignates subsections (f), (g), and (h) of section 167 as subsections (g), (h), and (i), respectively.

Paragraph (1) of section 167(f) provides the general rule that, under regulations prescribed by the Secretary of the Treasury or his delegate, a taxpayer may, for purposes of computing the allowance for depreciation with respect to personal property, reduce the amount taken into account as salvage value by an amount which does not exceed 10 percent of the basis of such property (as determined under sec. 167(g) as of the time as of which such salvage value is required to be determined). For example, a taxpayer purchases depreciable personal property on January 1, 1963, for \$10,000. The estimated useful life of the property is 10 years and the estimated salvage value if \$500. The taxpayer uses the straight-line method of depreciation. Under present law the taxpayer would take depreciation deductions of \$950 in each of the 10 years of the useful life of the property. However, under section 167(f) the taxpayer may reduce salvage value, for purposes of computing the allowable depreciation deduction, by 10 percent of \$10,000. Since this amount, \$1,000, is greater than the estimated salvage value, \$500, the salvage value may be reduced to zero and the taxpayer may deduct \$1,000 in each year of the useful life of the property. In the above case, if the taxpayer had taken into account salvage value of only \$700 but the estimated salvage value had actually been \$1,500, the Internal Revenue Service could not adjust the amount used by the taxpayer since the reduction of salvage value by 8 percent of basis would be within the privilege granted by the new section 167(f).

Paragraph (2) of section 167(f) defines "personal property" as depreciable personal property (other than livestock) with a useful life of 3 years or more acquired after the date of the enactment of the Revenue Act of 1962.

(d) *Special rule for charitable contributions of section 1245 property.*—Subsection (d) of section 13 of the bill adds a new subsection (e) to section 170 of the code (relating to deductions for charitable contributions). Under the new subsection, the amount of a charitable contribution of section 1245 property will be reduced by the amount which would have been treated as gain to which section 1245(a) applied if the property had been sold at its fair market value instead of contributed to the charity. For example, a taxpayer owns depreciable property with an adjusted basis of $10,000, a recomputed basis of $14,000, and a fair market value of $17,000. If the property were sold for $17,000, gain of $4,000 under section 1245(a) would result. Assume that the taxpayer contributes the property to a qualifying charitable organization. Under the new section 170(e) the amount of the charitable contribution would be $13,000 ($17,000 minus $4,000).

(e) *Computation of taxable income for purposes of limitation on percentage depletion deduction.*—Subsection (e) of section 13 of the bill, which has no corresponding provision in the bill as passed by the House, inserts a new sentence after the second sentence in section 613(a), relating to the general rule for computing percentage depletion. The new sentence, which does not affect the computation of the gross income from the property under the first sentence of section 613(a), provides that the allowable deductions taken into account with respect to expenses of mining in computing taxable income from the property shall, for purposes of the 50-percent limitation contained in the second sentence of section 613(a), be decreased by the gain recognized under section 1245(a) which is properly allocable to the property.

(f) *Technical amendments.*—This subsection of the bill is identical to subsection (e) of the bill as passed by the House. Paragraph (1) of section 13(f) of the bill amends section 751(c) of the code to provide that, for purposes of section 751 (relating to unrealized receivables and inventory items), section 731 (relating to extent of gain or loss on distribution), section 736 (relating to payments to a retiring partner or a deceased partner's successor in interest), and section 741 (relating to recognition and character of gain or loss on sale or exchange), the term "unrealized receivables" will include section 1245 property, but only to the extent of the amount which would be treated as gain to which section 1245(a) applied if the property were sold by the partnership at its fair market value. Thus, the rules provided in section 751 with respect to unrealized receivables will also apply with respect to section 1245 property, to the extent of the potential section 1245(a) gain. For example, if a partner sold his interest in a partnership to a third party, the portion of the amount realized on such sale allocable to the partner's share of the potential section 1245(a) gain on the section 1245 property of the partnership will be recognized to the partner.

Paragraph (2) of section 13(f) of the bill amends section 301 (b) and (d) of the code (relating to the amount distributed and basis in a corporate distribution of property) by striking out "subsection (b) or (c) of section 311" and inserting in lieu thereof "subsection (b) or (c) of section 311 or under section 1245(a)."

Paragraph (3) of section 13(f) of the bill amends section 312(c)(3) (relating to adjustments to earnings and profits) by striking out

"subsection (b) or (c) of section 311" and inserting in lieu thereof "subsection (b) or (c) of section 311 or under section 1245(a)."

Paragraph (4) of section 13(f) of the bill adds a new paragraph (12) to section 341(e) (relating to collapsible corporations). New paragraph (12) provides that, for purposes of section 341(e), the determination of whether gain from the sale or exchange of property would be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b) is to be made without regard to the application of section 1245(a).

Paragraph (5)(A) of section 13(f) of the bill adds a new sentence at the end of section 453(d)(4)(A), relating to distribution of installment obligations in complete liquidations of subsidiaries under section 332. Section 453(d)(4)(A) provides that if an installment obligation is distributed by one corporation to another corporation and if under section 332 no gain or loss is recognized to the recipient corporation with respect to the receipt of such obligation, then no gain or loss with respect to the distribution of such obligation is recognized to the distributing corporation. The new sentence provides that if section 334(b)(2) (relating to the basis of property received in certain liquidations to which sec. 332 applies) applies in respect of property received by the distributee corporation, then the rule of existing law is not to apply to the extent that under paragraph (1) of section 453(d) gain to the distributing corporation would be considered as gain to which section 1245(a) applies. For example, assume that corporation X sells section 1245 property and returns its income therefrom on the installment method under section 453. Corporation Y then buys all the outstanding stock of X and within 2 years after the purchase X adopts a plan of complete liquidation. If an installment obligation received by X upon the sale of the section 1245 property is distributed to Y in the liquidation, gain will be recognized to X under paragraph (1) of section 453(d) to the extent that the excess of the fair market value of the obligation over its basis constitutes gain to which section 1245(a) applies.

Paragraph (5)(B) of section 13(f) of the bill adds a new sentence at the end of section 453(d)(4)(B), relating to distribution of installment obligations in liquidations to which section 337 applies. Section 453(d)(4)(B) provides that if an installment obligation is distributed by a corporation in the course of a liquidation and if under section 337 no gain or loss would have been recognized to the corporation if the corporation had sold or exchanged such obligation on the day of the distribution, then no gain or loss is recognized to the corporation by reason of the distribution. The new sentence provides that the preceding rule is not to apply to the extent that under paragraph (1) of section 453(d) gain to the distributing corporation would be considered as gain to which section 1245(a) applies. For example, assume that corporation X, which makes its return on the basis of the fiscal year ending June 30, adopts a plan of complete liquidation on March 15. On June 15, X sells section 1245 property and returns its income therefrom on the installment method under section 453. On October 15, X distributes all of its property (including an installment obligation received in respect of the sale) in complete liquidation. Gain will be recognized to X under paragraph (1) of section 453(d) to the extent that the excess of the fair market value of the installment

obligation over its basis constitutes gain to which section 1245(a) applies.

(g) *Effective dates.*—Subsection (g) corresponds to subsection (f) of the bill as passed by the House which provided that the amendments made by this section of the bill shall apply to taxable years beginning after December 31, 1961, and ending after the date of the enactment of the bill. Your committee's amendment provides that the amendments made by this section shall apply to taxable years beginning after December 31, 1962, except that subsection (c) of this section shall apply to taxable years beginning after December 31, 1961, and ending after the date of enactment of the bill.

SECTION 14. FOREIGN INVESTMENT COMPANIES

(a) *Treatment of sale of stock of foreign investment companies.*—Section 14(a) of the bill adds to the code a new section 1246 (relating to gain on foreign investment company stock) and a new section 1247 (relating to election by foreign investment companies to distribute income currently). Section 1246 provides for the inclusion as ordinary income of certain gains from the sale or exchange of stock in a foreign investment company. However, section 1246 will not apply to the qualified shareholders of a registered foreign investment company which elects, under section 1247, to distribute its income currently.

This section is substantially similar to section 15 of the bill as passed by the House. However, your committee has made certain clarifying changes and has added a provision permitting a foreign investment company which elects to distribute its income currently to make a further election, if more than 50 percent of the value of its assets consists of stock or securities in foreign corporations, to allow its shareholders to treat as paid by them their proportionate shares of the foreign taxes paid by the investment company. Your committee has also added a provision allowing registered foreign investment companies the opportunity to reincorporate tax free in the United States without obtaining a ruling from the Commissioner under section 367.

SECTION 1246. GAIN ON FOREIGN INVESTMENT COMPANY STOCK

(a) *Treatment of gain as ordinary income.*—Under subsection (a)(1) of section 1246, the bill as passed by the House provided that any gain from the sale or exchange after December 31, 1962, of stock to which the subsection applies is to be treated as gain from the sale or exchange of property which is not a capital asset, but only to the extent of the taxpayer's ratable share of the earnings and profits of the company accumulated for taxable years beginning after December 31, 1962. Your committee has amended this provision to make it clear that any gain upon a distribution which, under section 302 or 331, is treated as a sale or exchange of stock shall be given the same treatment. Any additional gain or any loss on the sale or exchange of such stock will remain unaffected by these provisions. Subsection (a)(1) applies to stock in a foreign corporation which was a foreign investment company at any time during the period during which the taxpayer held such stock. Thus subsection (a)(1) applies whether or not the foreign corporation is within the definition of a foreign

investment company at the time of the sale or exchange. However, since under section 14(c) of the bill, section 1246 applies only with respect to taxable years beginning after December 31, 1962, the corporation must have been a foreign investment company while the taxpayer held the stock at some time during such a taxable year.

Subsection (a)(2) of the new section 1246 provides that the taxpayer's ratable share of the accumulated earnings and profits is to be determined under regulations prescribed by the Secretary of the Treasury or his delegate. Such determination is to include only the taxpayer's ratable share of the earnings and profits of the foreign corporation accumulated for the period during which the taxpayer held stock in such foreign corporation (excluding any portion of such period occurring in a taxable year of the corporation beginning before January 1, 1963). The bill provides that such determination will exclude the taxpayer's share of undistributed earnings and profits which previously had been taxed to him under section 951 (relating to amounts included in gross income of U.S. persons, added by sec. 12 of the bill) or under section 551 (relating to foreign personal holding company income taxed to U.S. shareholders). Under the bill as amended by your committee only such earnings and profits attributable to any amount previously included in the gross income of such taxpayer under section 951 will be excluded, and then only to the extent that such inclusion under section 951 did not result in an exclusion of any other amount from gross income under section 959. The amount of the accumulated earnings and profits for any period is determined after applying the rules of the code that distributions are treated as made out of the most recently accumulated earnings and profits.

Subsection (a)(3) of the new section 1246 requires the taxpayer to establish the amount of the accumulated earnings and profits of the foreign corporation and his ratable share of such amount. He must establish this information for the period during which he held such stock, including whatever holding period is required by other subsections of section 1246. Failure to establish this information will result in all the gain from the sale or exchange of such stock being considered as gain from the sale or exchange of property which is not a capital asset.

Subsection (a)(4) of the new section 1246 provides that section 1246 is not to apply where the holding period of the stock as of the date of the sale or exchange is 6 months or less.

(b) *Definition of foreign investment company.*—The definition of foreign investment company in subsection (b) of section 1246 has been amended by your committee. The House bill defined a foreign investment company as any foreign corporation which satisfied one of two alternative tests. Your committee bill provides that either of these two tests must be satisfied for any taxable year beginning after December 31, 1962, in order for a foreign corporation to be a foreign investment company. The first test is met if the foreign corporation is registered under the Investment Company Act of 1940, as amended (15 U.S.C. 80a–1 to 80b–2), either as a management company or as a unit investment trust. Under the Investment Company Act of 1940, an investment company organized or created under the laws of a foreign country is required to register with the Securities and Exchange Commission in order to make a public offering of its securities in the United States. The act defines an investment company, in

general, as any issuer of securities which is or holds itself out as being engaged primarily in the business of investing, reinvesting, or trading in securities. Under the second test provided by the new section 1246(b), a foreign corporation, even though it does not make a public offering of its securities and does not register under the act, is a foreign investment company if it satisfies two conditions. The first condition under the House bill was that the foreign corporation must be engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities (within the meaning of sec. 3(a)(1) of the act). The bill as amended by your committee provides that section 3(a)(1) of the act would be limited by paragraphs (2) through (10) (except par. (6)(C)) and paragraphs (12) through (15) of section 3(c) of such act for purposes of determining if the first condition is satisfied. The effect of your committee's amendment is to exclude from foreign investment company treatment certain foreign corporations such as, for example, brokers, banks, and small loan companies. Under the second condition, the first condition must be satisfied at a time when more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock, was held directly or indirectly (within the meaning of sec. 958(a) of the code, added by sec. 12 of the bill), by U.S. persons (as defined in sec. 7701(a)(30) of the code, added by sec. 7(h) of the bill). Under the Investment Company Act of 1940, the term "security" is defined broadly and includes among others, stock, treasury stock, bond, debenture, any evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, certificate of deposit for a security, or a fractional undivided interest in oil, gas, or other mineral rights.

(c) *Stock having transferred or substituted basis.*—Subsection (c) of new section 1246 provides that stock in a foreign corporation, the basis of which (in the hands of the taxpayer selling or exchanging such stock) is determined by reference to the basis (in such taxpayer's hands or any other person's hands) of stock in a foreign investment company, will to the extent provided in regulations prescribed by the Secretary of the Treasury or his delegate be treated as stock of a foreign investment company. The stock which is so treated will be considered under section 1223 (relating to holding period of property) to be held by the taxpayer throughout the period during which the foreign investment company stock was held in addition to the period during which the stock in the foreign corporation is held. Transactions to which subsection (c) applies include the following:

A person owning stock in a foreign investment company transfers such stock to foreign corporation F which he controls in exchange for stock of corporation F in a transaction to which section 351 applies. Clearance under section 367 is obtained. The stock of corporation F received in exchange for the foreign investment company stock will be considered stock of a foreign investment company. If the stock of corporation F is later transferred by gift, the donee will also treat such stock as stock of the foreign investment company and the holding period of the donee will include the period during which the donor held the stock in the foreign investment company and corporation F.

(d) *Rules relating to entities holding foreign investment stock.*—Subsection (d) of the new section 1246 provides that to the extent

provided in regulations prescribed by the Secretary of the Treasury or his delegate, trust certificates of a trust to which section 677 (relating to income for benefit of grantor) applies, and stock in a domestic corporation, will be treated as stock of a foreign investment company to the extent that such trust or corporation has an investment in stock in a foreign investment company. As a result of this provision the taxpayer is deemed to be holding stock of the foreign investment company. The trust certificates or stock are to be treated under section 1223 as held by the taxpayer throughout the holding period for which the trust or domestic corporation held stock in a foreign investment company, but limited to the period during which the taxpayer held such trust certificates or stock in the domestic corporation. Such stock is deemed to be held by him in the same proportion that the actual investment in stock in a foreign investment company by the trust or domestic corporation bears to the total assets of such trust or domestic corporation. For example, if a domestic corporation has an investment of $20,000 in stock of a foreign investment company and total assets of $100,000, the proportion of the domestic corporation's investment is 20 percent. Therefore, 20 percent of each share of stock in such corporation will be deemed to be foreign investment stock and 20 percent of the gain, if any, resulting from the sale or exchange thereof, will be subjected to section 1246 treatment.

(e) *Rules relating to stock acquired from a decedent.*—Paragraph (1) of subsection (e) sets forth the manner for computing the basis of stock in a foreign investment company which is acquired from a decedent dying after December 31, 1962, and treats the holding period by the heir or successor in the manner provided for in subsection (c). Under paragraph (1) of subsection (e) the stock's basis determined under section 1014 will be reduced by the decedent's ratable share of the company's earnings and profits accumulated in taxable years beginning after December 31, 1962. For example, if the stock had an adjusted basis of $100, a fair market value of $150 on the date of the decedent's death, and $30 was the decedent's ratable share of the accumulated earnings and profits during the period he held such stock after December 31, 1962, the person acquiring the stock from the decedent would have a basis of $120 ($150—$30). In no case is the basis determined under section 1014 to be reduced below the adjusted basis of the stock in the hands of the decedent immediately before his death, regardless of the decedent's ratable share of such earnings. Thus, in the above example, the basis could not be reduced below $100.

The stock so acquired from a decedent shall be treated as if it were held throughout the holding period of the decedent in addition to the holding period of the person acquiring the stock. Thus, in effect, the holding period of the decedent is tacked onto that of the person acquiring the stock. If, in the example illustrated in the preceding paragraph, the stock were sold immediately after acquisition at its fair market value of $150, the gain of $30 ($150—$120) would be treated as gain from the sale of property which is not a capital asset. If, after acquisition the stock further increased in value, upon a sale or exchange, $30 plus the portion of the gain which is equal to the taxpayer's ratable share of the accumulated earnings and profits of the corporation for the period during which he held such stock would be treated in the same manner.

In the event the decedent's executor decides to determine the gross estate under section 2032 (relating to alternate valuation), for purposes of section 1246(e), the date the stock is so valued will be considered the date of the decedent's death. Therefore, the basis determined at such later date will be reduced by the decedent's ratable share of the earnings and profits accumulated during the period preceding the date of his death and the earnings and profits accumulated during the period between such date and the date of alternate valuation.

Paragraph (2) of section 1246(e) provides that if foreign investment company stock acquired from a decedent is sold or exchanged at a gain which gain is subject to ordinary income treatment under subsection (a) of section 1246, the taxpayer, under regulations prescribed by the Secretary of the Treasury or his delegate, is to be allowed a deduction from gross income, for the taxable year of the sale or exchange, equal to that portion of the decedent's estate tax deemed paid which is attributable to the excess of (A) the value at which such stock was taken into account for purposes of determining the value of the decedent's gross estate, over (B) the value at which it would have been so taken into account if such value had been reduced by the amount representing the reduction in basis described in paragraph (1). The value determined in (B) is actually the taxpayer's basis of the stock as determined under section 1246(e)(1). The provision of paragraph (1) may be illustrated by the following example:

Example

The gross estate of a decedent dying in 1963 was $125,000, which included foreign investment company stock valued at $5,000. Assuming deductions of $10,000 and an exemption of $60,000, the taxable estate amounted to $55,000. The estate tax paid on this amount is $8,250. Assuming that the decedent's share of earnings and profits accumulated after December 31, 1962, was $500 the heir's basis for such stock determined under section 1246(e)(1) would be $4,500. If the heir sold such stock in 1963, he is allowed to deduct the following amount from his 1963 gross income:

Estate tax actually paid (on taxable estate of $55,000)	$8, 250
Less: Estate tax computed by reducing the gross estate by $500 (tax on taxable estate of $54,500)	8, 125
Amount deducted from the heir's gross income	125

If in 1963, the heir had sold only one-half of the stock, then only $62.50 (one-half of $125) could have been deducted from his gross income.

(f) *Information with respect to certain foreign investment companies.*—Subsection (f) of section 1246 requires certain U.S. shareholders of a foreign investment company to furnish with respect to such company such information as the Secretary of the Treasury or his delegate shall by regulations prescribe. The requirement is applicable only to those U.S. persons who on the last day of the taxable year of a foreign investment company beginning after December 31, 1962, own 5 percent or more in value of the stock of such company.

(g) *Nonapplication of section 367 in certain cases.*—Your committee has redesignated subsection (g) of section 1246 in the bill as passed by the House as subsection (h) and has added a new subsection (g) which has no corresponding provision in the bill as passed by the House. The new subsection (g) provides that if a registered foreign investment company described in subsection (b)(1) has made an effective election

to distribute income currently under section 1247 with respect to taxable years beginning after December 31, 1962, then section 367 will not apply in respect of such foreign investment company if the company is a party to a reorganization (within the meaning of sec. 368) in which all of its properties are acquired before January 1, 1964, by a domestic corporation which is a regulated investment company under section 851 for its first taxable year ending after the reorganization.

(h) *Cross-reference.*—Subsection (h) of section 1246, which corresponds to subsection (g) in the bill as passed by the House, is a cross-reference to section 312(l) of the code (relating to effect on earnings and profits of foreign investment companies) which is added by section 14(b)(1) of the bill.

SECTION 1247. ELECTION BY FOREIGN INVESTMENT COMPANIES TO DISTRIBUTE INCOME CURRENTLY

Section 1247, which is added to the code by section 14(a) of the bill, provides that section 1246 will not apply to the shareholders of a registered foreign investment company if such company makes the election provided for by section 1247, and if the shareholders include in their income their pro rata share of the excess of the net long-term capital gain over the net short-term capital loss of the company for each taxable year.

(a) *Election by foreign investment company.*—Section 1247(a)(1) provides that if a foreign investment company of the type defined in section 1246(b)(1) (relating to registered foreign investment companies) makes the election provided by section 1247, section 1246 will not apply with respect to its qualified shareholders during any taxable year of the company to which the election is effective. Such election must be made on or before December 31, 1962, in the manner provided in regulations prescribed by the Secretary of the Treasury or his delegate. The election commits the company to fulfill the requirements provided in subparagraphs (A), (B), and (C) of subsection (a)(1) for each taxable year beginning after December 31, 1962.

Under subparagraph (A), the company elects to distribute to its shareholders during each taxable year at least 90 percent of its taxable income for such year. For this purpose, taxable income is the amount determined as if such company were a domestic corporation but with the adjustments provided in subparagraph (A) of paragraph (2).

Under subparagraph (B), the bill provided that the company elects to designate, in a written notice mailed to its shareholders at any time before 30 days after the close of its taxable year, the pro rata amount of the excess of the net long-term capital gain over the net short-term capital loss and the portion thereof which is being distributed. The bill as amended by your committee provides that the written notice shall be mailed at any time before 45 days after the close of such taxable year. Such determinations are to be made as if such company were a domestic corporation.

Under subparagraph (C), the company elects to provide such information as the Secretary of the Treasury or his delegate deems necessary to carry out the purposes of section 1247.

Paragraph (2)(A) of subsection (a) provides special rules for computing taxable income under paragraph (1)(A).

Subparagraph (A) states that such taxable income will be determined without regard to—

(i) the excess of the net long-term capital gain over net short-term capital loss for the taxable year,

(ii) the net operating loss deduction under section 172, and

(iii) the deductions provided in part VIII of subchapter B (relating to special deductions for corporations), other than the deduction provided in section 248 (relating to organizational expenses).

Paragraph (2)(B) provides that in determining the amount of the distribution made under paragraph (1)(A), a distribution made after the close of the taxable year but on or before the 15th day of the third month of the next taxable year will be treated by the company (but not by its shareholders) as distributed during the earlier year to the extent elected by the company on or before the 15th day of such third month. Such election is to be made in accordance with regulations prescribed by the Secretary of the Treasury or his delegate.

Subparagraph (C) of paragraph (2) provides that for purposes of making the computations under paragraph (1)(B), any capital loss under section 1212 incurred prior to the first effective year of the election will not be carried forward to the period for which the election is effective.

(b) *Years to which election applies.*—Subsection (b) of the new section 1247 provides that the election is to terminate starting with the first day of the first taxable year in which—

(1) the company fails (unless it is shown that such failure is due to reasonable cause and not due to willful neglect) at any time to comply with any of the requirements set forth in subsection (a)(1),

(2) the company is a foreign personal holding company, or

(3) the company is not a registered foreign investment company as described in section 1246(b)(1).

It is recognized that some registered foreign investment companies may experience difficulties in ascertaining the extent to which distributions which they receive on investments in stocks of other foreign corporations represent income to them under the standards of the Internal Revenue Code; for example, this may be true with respect to distributions from foreign mining companies. The bill provides in section 1247(b)(1) that the company will not be disqualified under section 1247 if its failure to distribute 90 percent of its income is due to reasonable cause and not due to willful neglect. If in determining its income, the company relies in good faith upon estimates and opinions of independent certified public accountants or other experts which are also used for purposes of its financial statements filed with the Securities and Exchange Commission under the Investment Company Act of 1940, such reliance would constitute reasonable cause for this purpose.

(c) *Qualified shareholders.*—Paragraph (1) of subsection (c) of section 1247 defines a "qualified shareholder" to mean a shareholder who is a U.S. person (as defined in sec. 7701(a)(30), added by sec. 7(h) of the bill) other than a shareholder described in paragraph (2).

Paragraph (2) provides that a U.S. person is not to be treated as a qualified shareholder for his taxable year if for such taxable year (or for any prior taxable year) he fails to include (in computing his long-term capital gains in his return for such taxable year) the amount designated by the company as his pro rata share of the undistributed

portion of the excess of the net long-term capital gain over the net short-term capital loss of the company for the company's taxable year ending within or with the shareholder's taxable year. Once a taxpayer fails to comply with the provisions of this paragraph in determining his status as a qualified shareholder, he loses the benefits of a qualified shareholder for the duration of the election and section 1246 will apply when he sells or exchanges the stock of the foreign investment company at a gain. However, if a taxpayer can show that the failure to include his share of the undistributed capital gains in his return was due to reasonable cause and not due to willful neglect, he will continue to be treated as a qualified shareholder.

(d) *Treatment of distributed and undistributed capital gains by qualified shareholders.*—Your committee has redesignated subsection (d) (relating to adjustments) of the new section 1247 as subsection (e) and has substituted a new subsection (d) which has no corresponding provision in the bill as passed by the House. The new subsection (d) provides rules for the treatment at the shareholder level of the distributed and undistributed portions of certain capital gains of a foreign investment company. Such capital gains are the excess of the net long-term capital gain over the net short-term capital loss for each taxable year of a foreign investment company with respect to which an election pursuant to subsection (a) is in effect. These rules for the treatment of such gains apply only to shareholders of such company who are qualified shareholders within the meaning of subsection (c).

Paragraph (1) of subsection (d) provides that every qualified shareholder of such company shall include his pro rata share of the distributed portion of such capital gains of such company in computing his long-term capital gains for his taxable year in which such distributed portion is received. Rules of existing law will continue to apply with respect to the receipt of such amounts by shareholders who are not qualified shareholders within the meaning of subsection (c). Accordingly, an unqualified shareholder would treat his pro rata share of the distributed portion of such capital gains as dividend income taxable at ordinary income rates.

Paragraph (2) of subsection (d) provides that every qualified shareholder of such company, in computing his long-term capital gains for his taxable year in which or with which the taxable year of the company ends, shall include his pro rata share of the undistributed portion of such capital gains for the taxable year of the company.

(e) *Adjustments.*—Subsection (e) of the new section 1247, which corresponds to subsection (d) in the bill as passed by the House, provides that proper adjustment, under regulations prescribed by the Secretary of the Treasury or his delegate, shall be made to reflect the inclusion in gross income of a qualified shareholder of his pro rata share of the undistributed portion of such capital gains under subsection (d)(2).

Under paragraph (1), the bill as passed by the House provided that such adjustment shall be made to the earnings and profits of the electing foreign investment company. The bill as reported provides in addition that such adjustment shall be made to a qualified shareholder's ratable share of such earnings and profits.

Paragraph (2), provides that adjustment shall also be made to the adjusted basis of stock held by qualified shareholders of the company.

(f) *Election by foreign investment company with respect to foreign tax credit.*—Subsection (f) of the new section 1247, for which there is no corresponding provision in the bill as passed by the House, provides that certain foreign investment companies may elect to be treated as conduits for the purposes of income, war profits, and excess profits taxes described in section 901(b)(1) which such companies pay to foreign countries and possessions of the United States. If such an election is made, the qualified shareholders may apply their proportionate shares of such foreign taxes either as a credit under section 901 or as a deduction under section 164(a) to the same extent as if they had paid such foreign taxes. The election may be made by a foreign investment company for any taxable year with respect to which an election pursuant to subsection (a) is in effect, if more than 50 percent of the value of the company's total assets at the close of such taxable year consists of stock or securities in foreign corporations. The conduit treatment provided in this subsection is not available with respect to taxes deemed to have been paid under section 902 (relating to the credit allowed to corporate shareholders of a foreign corporation for taxes paid by such foreign corporation).

If a foreign investment company for a taxable year elects the conduit treatment for foreign taxes under subsection (f), the determination of whether the election under subsection (a) is in effect for such taxable year is made in accordance with the rules provided in paragraph (1) of subsection (f). Under these rules, taxable income of the foreign investment company is computed without any deductions for income, war profits, or excess profits taxes (which are described in sec. 901(b)(1)) paid to foreign countries or possessions of the United States and the amount of such taxes are treated as distributed to shareholders for purposes of satisfying the requirement in subsection (a)(1)(A) that at least 90 percent of taxable income be distributed.

Under paragraph (2) of subsection (f), each qualified shareholder of the foreign investment company making the election under this subsection is required to include in his gross income and treat as paid by him his proportionate share of foreign taxes described in subsection (f)(1)(A), which were paid by the foreign investment company. For purposes of applying the foreign tax credit, the qualified shareholder shall treat his proportionate share of such taxes as having been paid to the country in which the foreign investment company is incorporated.

(g) *Notice to shareholders.*—Subsection (g) of section 1247, for which there is no corresponding provision in the bill as passed by the House, provides that the amounts to be treated by a qualified shareholder, for purposes of subsection (f)(2), as his proportionate share of taxes described in subsection (f)(1)(A) paid by the foreign investment company shall not exceed the amounts designated by the foreign investment company in a written notice mailed to its shareholders not later than 45 days after the close of its taxable year.

(h) *Manner of making election and notifying shareholders.*—This subsection, which has no corresponding provision in the bill as passed by the House, provides that the election by the foreign investment company to make the foreign tax credit available to its shareholders under subsection (f) and the notice to its shareholders of the designation of certain amounts under subsection (g) shall be made in the manner provided in regulations to be prescribed by the Secretary of the Treasury or his delegate.

(i) *Loss on sale or exchange of certain stock held less than 6 months.*—Subsection (i) which is identical to subsection (e) of section 1247 of the bill as passed by the House, provides that if a share of stock is held by a qualified shareholder for less than 6 months and if he treats any amount designated under section 1247(a)(1)(B) as long-term capital gain with respect to such shares, then any loss on the sale or exchange of such share (to the extent of the amount so treated as long-term capital gain) shall be treated as loss from the sale or exchange of a capital asset held for more than 6 months. For example, on December 20, 1963, A purchases a share of stock in corporation F, an electing foreign investment company, for $50. Corporation F (which is on a calendar-year basis) designates A's share of its long-term capital gains for the year 1963 as being $5. No distribution with respect to capital gains is made. A, therefore, includes $5 in computing his long-term capital gains in his return for 1963. On January 10, 1964, A sells such share for $49. Since A has a basis of $55 (the $50 original cost plus the $5 capital gain included in income but not distributed) the sale results in a loss of $6. Subsection (e) treats $5 of this loss as a long-term capital loss.

SECTION 14. FOREIGN INVESTMENT COMPANIES (Continued)

(b) *Conforming amendments.*—Paragraph (1) of section 14(b) of the bill amends section 312 of the 1954 Code (relating to effect on earnings and profits) by adding after subsection (k) thereof a new subsection (l).

Paragraph (1) of subsection (l) provides that upon the sale or exchange of stock in a foreign investment company by a shareholder who is a U.S. person, if such foreign investment company is a member of an affiliated group (as defined in par. (2)), then the accumulated earnings and profits of all member companies are to be allocated under regulations prescribed by the Secretary of the Treasury or his delegate, in such a manner as to carry out the purposes of section 1246.

Paragraph (2) of subsection (l) defines the term "affiliated group" for purposes of subsection (l)(1) to have the same meaning as such term has in section 1504(a) except that (A) "more than 50 percent" is substituted for "80 percent or more" wherever appearing in section 1504(a), and (B) all corporations are treated as includible corporations without regard to section 1504(b).

Paragraph (3) of new subsection (l) provides a rule governing the reduction in the earnings and profits of a foreign investment company as a result of amounts distributed by a foreign investment company in a partial liquidation or in redemptions to which section 302(a) or 303 applies. The portion of the distribution which is chargeable to earnings and profits shall be an amount which is not in excess of the redeemed stock's ratable share of the earnings and profits of the company accumulated after February 28, 1913. The effect of this provision is to allocate to each share of stock (whether or not redeemed) an equal amount of the company's accumulated earnings and profits at the time of the redemption. Paragraph (3) of subsection (l) applies only to such distributions made after December 31, 1962. The application of subsection (l)(3) of section 312 may be illustrated by the following example: Corporation F, a foreign investment company, has

accumulated earnings and profits of $10,000 on December 31, 1963, on which date corporation F redeems shareholder A's stock for cash in the amount of $4,000. A is a 20-percent shareholder. Under the amendment the earnings and profits of the corporation are reduced by only $2,000 (20 percent of $10,000).

Paragraph (2) of section 14(b) of the bill amends section 751(d)(2) of the code (relating to inventory items of a partnership which have appreciated substantially in value) by adding new subparagraphs (C) and (D) which provide treatment for the sale or exchange of an interest in a partnership which holds stock in a foreign investment company. The amendment treats foreign investment company stock as an inventory item of the partnership under subsection (d)(2) of section 751. If an interest in a partnership, holding stock in a foreign investment company, is sold or exchanged, and if section 1246(a) would apply to the gain on the sale or exchange of such stock were such stock sold or exchanged by the partnership, the amount received for such interest which is attributable to the inventory items under section 751(d)(2) (including foreign investment company stock) will be taxed at ordinary income rates, provided under section 751(d)(1) the substantial appreciation tests for inventory items of the partnership are satisfied.

Paragraph (3) of section 14(b) of the bill amends section 1223 of the code (relating to holding period of property) by redesignating paragraph (10) as paragraph (11) and adding a new paragraph (10). Paragraph (10) requires a taxpayer in determining the period for which he held certain trust certificates to which section 1246(d) applies (relating to entities holding foreign investment company stock), or the period for which he held stock to which such section applies, to include the period for which the trust or corporation held the stock of foreign investment companies.

(c) *Effective date.*—Subsection (c) of section 14 of the bill provides that the amendments made by section 14 are to apply with respect to taxable years beginning after December 31, 1962.

SECTION 15. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS

(a) *Treatment of gain from the redemption, cancellation, or sale of stock in certain foreign corporations.*—Subsection (a) of section 15 of the bill, corresponding to section 16 of the bill as passed by the House, amends part IV of subchapter P of chapter 1 (relating to special rules for determining capital gains and losses) by adding after section 1247 (as added by sec. 14 of the bill) a new section 1248.

SECTION 1248. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS

Section 1248 provides that gain recognized on the sale or exchange of stock by a U.S. person owning 10 percent or more of the voting stock of a foreign corporation shall be included in gross income of such person as a dividend to the extent of the earnings and profits of the foreign corporation attributable to the period the stock sold or exchanged was held by such person while the foreign corporation was a controlled foreign corporation. Section 1248 also provides a limita-

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tion on the amount of tax payable by a U.S. person who is an individual, as defined in section 7701(a)(30)(A) (added by sec. 7 of the bill), and special rules for determining earnings and profits of a foreign corporation for purposes of this section.

(a) *General rule.*—Subsection (a) of section 1248 provides two prerequisites to the application of the section. First, a U.S. person, as defined in section 7701(a)(30), must sell or exchange stock in a foreign corporation. For this purpose, distributions under section 302, relating to distributions in redemption of stock, or section 331, relating to complete or partial liquidations of a corporation, are treated as exchanges. Second, a U.S. person must have owned within the meaning of section 958 (added by sec. 12 of the bill), 10 percent or more of the total combined voting power of all class of stock entitled to vote of the foreign corporation at any time during the 5-year period ending on the date of sale or exchange, and the foreign corporation must have been a controlled foreign corporation, as defined in section 957 (added by sec. 12 of the bill), on such date. If these conditions are satisfied, section 1248(a) requires that if a gain is recognized by the U.S. person on the sale or exchange of the stock of the foreign corporation, such amount of the gain as does not exceed the U.S. person's proportionate share of the earnings and profits of the foreign corporation attributable (under regulations prescribed by the Secretary of the Treasury or his delegate) to the stock sold or exchanged which were (1) accumulated in taxable years of the foreign corporation beginning after December 31, 1962, (2) during the period or periods the stock sold or exchanged was held by such person, and (3) while such foreign corporation was a controlled foreign corporation, shall be included in gross income of the U.S. person as a dividend. Section 1248 will not apply to exchanges in which gain is not recognized, for example, exchanges described in sections 332, 351, 354, 355, or 361 of the code, if before such exchange, as prescribed in section 367, it has been established to the satisfaction of the Secretary of the Treasury or his delegate that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

To the extent gain is included in gross income as a dividend, the pertinent rules of subpart A of part III of subchapter N, relating to foreign tax credits, apply. Thus, foreign-tax credits for amounts allowed under section 901(b) with respect to taxes paid, and section 902 with respect to taxes deemed to be paid, are allowable if the U.S. person chooses to have the benefits of such sections. That part of the gain in excess of the amount included in gross income as a dividend under section 1248 is treated as provided by the code without regard to new section 1248 and there is no foreign tax credit with respect to taxes paid by the foreign corporation as to the portion of the gain that is not a dividend.

The bill as passed by the House would have treated as a dividend gain attributable to earnings and profits of foreign corporations accumulated after February 28, 1913, and in taxable years of such corporations ending on or before December 31, 1962, or gain attributable to earnings and profits of foreign corporations for periods during which a U.S. person was a shareholder in a foreign corporation at a time

when the foreign corporation was not a controlled foreign corporation. The bill as passed by the House contained no provision for the allowance of a foreign tax credit in the case of the sale or exchange, other than in redemption or liquidation, of stock in a controlled foreign corporation.

The application of this subsection may be illustrated by the following examples:

Example 1.—A, an individual U.S. person, is, and always has been, the sole shareholder of foreign corporation X. X was organized on January 1, 1961, and had earnings and profits of $100 in the taxable year ending December 31, 1961, $200 in taxable year 1962, and $50 in taxable year 1963. A sold all his stock, a capital asset, in corporation X on December 31, 1963, and realized a gain of $400. Fifty dollars of the total gain (A's share of the earnings and profits of X for taxable year 1963) is includible in gross income of A as a dividend and $350 is includible in gross income of A as gain from the sale or exchange of a capital asset held for more than 6 months.

Example 2.—Assume the same facts as in example 1, except that A sold one-half of his shares in corporation X on December 31, 1963, rather than his entire stock interest, and realized a gain of $150. Twenty-five dollars of the total gain is includible in gross income of A as a dividend and the remaining $125 of gain is includible in gross income of A as gain from the sale or exchange of a capital asset held for more than 6 months.

Example 3.—U.S. person A, a domestic corporation, on January 1, 1963, owned 35 shares of stock in corporation X, a foreign corporation which was not a less developed country corporation. The remaining shares of X stock were held by U.S. individual B, 10 shares, and foreign corporation M, 55 shares. On January 1, 1964, A purchased 10 shares of corporation X stock from M and on January 1, 1965, A purchased 10 shares of corporation X stock from B. Corporation X had earnings and profits of $100 in each of the years 1963, 1964, and 1965 after payment of foreign income tax of $25 in each such year (20-percent rate). A sold all its stock in corporation X, 55 shares, on December 31, 1965, and realized a total gain of $500. Of the total gain, $100 (45 percent of the earnings and profits of 1964 and 55 percent of the earnings and profits of 1965 (corporation X was not a controlled foreign corporation in 1963)) is includible in gross income of A as a dividend and $400 is includible in gross income of A as gain from the sale or exchange of a capital asset held for more than 6 months. A, being a domestic corporation and owning at least 10 percent of the voting stock of foreign corporation X, could choose the foreign tax credit benefits of the code. Therefore, since foreign corporation X had paid a foreign income tax of 25 percent on the amount includible in income as a dividend, the inclusion of an amount under section 1248 would result in a net additional Federal income tax of 32 percent (assuming an effective U.S. tax rate of 52 percent) of the grossed-up amount included in gross income, a tax result equivalent to that which would have followed a distribution of earnings and profits to A by the controlled foreign corporation. The

amount of tax payable under this chapter would be computed as follows:

Amount includible in gross income as a dividend		$100.00
Amount included in gross income under sec. 78:		
1965: $25×55/100	$13.75	
1964: $25×45/100	11.25	
Total foreign tax paid with respect to $100		25.00
Total amount included in gross income		125.00
Tentative U.S. tax (at 52 percent rate)		65.00
Foreign tax credit (sec. 902)		25.00
Net U.S. tax		40.00

Example 4.—Assume the same facts as in example 3 except that A sold 30 shares of corporation X stock, rather than 55 shares, upon which A realized a total gain of $300. The shares sold represented 10 shares purchased from B on January 1, 1965, 10 shares purchased from corporation M on January 1, 1964, and 10 shares owned by A on January 1, 1963. Of the total gain, $50 (20 percent of the earnings and profits of 1964 ($20) and 30 percent of the earnings and profits of 1965 ($30)) is includible in gross income of A as a dividend, and $250 is includible as gain from the sale or exchange of a capital asset held for more than 6 months.

(b) *Limitation of tax applicable to individuals.*—Subsection (b) of section 1248, for which there is no corresponding provision in the bill as passed by the House, provides for a limitation of Federal income tax resulting from the inclusion in gross income of an individual U.S. person of an amount as a dividend under the provisions of section 1248(a).

Paragraph (1) of section 1248(b) provides that the tax attributable to an amount included in the gross income of a U.S. person in accordance with the provisions of section 1248(a) shall not be greater than an amount described in paragraph (2) or paragraph (3), whichever is lesser.

Paragraph (2) of section 1248(b) applies if the stock sold or exchanged, including distributions treated as exchanges under sections 302 or 331, is a capital asset, within the meaning of section 1221, and such stock has been held by the U.S. person for more than 6 months. If these conditions are met, the limitations of tax applicable to an amount includible in gross income of an individual U.S. person under section 1248(a) is an amount equal to the sum of the amounts determined under subparagraphs (A) and (B) of section 1248(b)(2), if such amount is less than the amount determined under paragraph (3) of section 1248(b).

Subparagraph (A) of section 1248(b)(2) provides for an amount equal to a pro rata share of the excess of an amount determined under the provisions of clause (i) over an amount determined under the provisions of clause (ii).

Clause (i) of section 1248(b)(2)(A) provides for an amount equal to the taxes that would have been paid by the foreign corporation had it been taxed under chapter 1 as a domestic corporation for the period or periods the stock sold or exchanged was held by the

U.S. person while the foreign corporation was a controlled foreign corporation in taxable years beginning after December 31, 1962. In determining the amount of Federal income tax the foreign corporation would have paid as a domestic corporation, the nature and amount of income of the foreign corporation will be determined under the provisions of the code as it relates to domestic corporations. Thus, gain on the sale of a capital asset held for more than 6 months is considered long-term capital gain, so much of taxable income as does not exceed $25,000 is exempt from surtax, etc. However, no deduction or credit will be allowable from gross income for income, war profits, or excess profits taxes paid by the foreign corporation. Income, deductions, credits, or allowances will be taken into account only for the period or periods the stock sold or exchanged was held by the U.S. person in taxable years beginning after December 31, 1962, while the foreign corporation was a controlled foreign corporation, adjusted for distributions and amounts previously included in gross income of a U.S. shareholder under section 951.

Clause (ii) of section 1248(b)(2)(A) provides for an amount equal to the income, war profits, or excess profits taxes paid by the foreign corporation with respect to income included in gross income under section 1248(a).

Subparagraph (B) of section 1248(b)(2) provides for an amount equal to a tax that would result by including in gross income of the individual U.S. person, as gain from the sale or exchange of a capital asset, an amount equal to the amount included in gross income in accordance with the provisions of section 1248(a), reduced by the amount determined under subparagraph (A) of section 1248(b)(2).

The application of section 1248(b)(2) may be illustrated by the following example involving individual U.S. person A who owns 100 percent of the stock of foreign corporation X. A purchased the stock of corporation X on January 1, 1963, and sold the stock on December 31, 1963. Corporation X files its income tax returns on a calendar year basis. For taxable year 1963, the entire income of corporation X was derived from the purchase and sale of property held for sale to customers in the ordinary course of trade or business. The profit or loss statement of corporation X is summarized as follows:

	1963
Gross receipts	$300, 000
Cost of goods sold	125, 000
Gross income	175, 000
Rent, salaries, utilities, etc	75, 000
Taxable income	100, 000
Foreign income tax (10 percent)	10, 000
Earnings and profits	90, 000

A realized $120,000 gain on the sale of the stock and was required, under the provisions of section 1248(a), to include $90,000 in gross income as a dividend and $30,000 as long-term capital gain. Without the application of section 1248(b), the tax attributable to the inclusion of $90,000 in gross income of A as a dividend was $63,000, an effective

tax rate of 70 percent. The limitation of section 1248(b)(2) would be computed as follows:

(i) An amount determined under section 1248(b)(2)(A):

(*a*) An amount determined under clause (i) of section 1248(b)(2)(A): Taxable income of corporation X under chapter 1 of the code, $100,000, upon which corporation X would have paid Federal income tax of $46,500

(*b*) An amount determined under clause (ii) of section 1248(b)(2)(A): Income tax paid by corporation X 10,000

(*c*) The amount determined under subparagraph (A) is the excess of the amount determined under clause (i) over the amount determined under clause (ii) ((*a*) minus (*b*)) $36,500

(ii) An amount determined under section 1248(b)(2)(B):

(*a*) The amount included in gross income under section 1248(a) $90,000

(*b*) The amount determined under subparagraph (A) of section 1248(b)(2) 36,500

(*c*) The amount treated as long-term capital gain for purposes of subparagraph (B) ((*a*) minus (*b*)) 53,500

(*d*) Tax that would have resulted from including $53,500 in gross income as a long-term capital gain (25 percent of $53,500) 13,375

(iii) The limitation of tax attributable to the inclusion of $90,000 in gross income as a dividend under section 1248(b)(2) is (item (i) plus (ii)) 49,875

Paragraph (3) of section 1248(b) provides for an alternative limitation of tax applicable to an amount includible in gross income of an individual U.S. person under section 1248(a) equal to the aggregate additional Federal income tax which would have been paid by the individual U.S. person had he included in gross income as a dividend his pro rata share of the undistributed earnings and profits of the foreign corporation for the period or periods the stock sold or exchanged was held by such person while such foreign corporation was a controlled foreign corporation in taxable years of the foreign corporation beginning after December 31, 1962.

(c) *Special rules.*—Subsection (c) of section 1248 provides that certain amounts included in earnings and profits of a foreign corporation, determined in accordance with rules substantially similar to those applicable to domestic corporations, will be excluded from earnings and profits of the foreign corporation for purposes of section 1248.

Paragraph (1) of section 1248(c) correlates section 1248 with section 951 (added by sec. 12 of the bill) by reducing the amount of gain considered a dividend under subsection (a) by the U.S. person's proportionate share of earnings and profits of the foreign corporation, attributable to the stock sold or exchanged, which had been previously included in the gross income of the U.S. person by the application of subpart F of part III of subchapter N. However, such amounts previously included in the gross income of the U.S. person under section 951 are reduced by amounts, attributable to the stock sold or exchanged, subsequently distributed by the foreign corporation and excluded from gross income of the U.S. person under section 959.

The application of this paragraph may be illustrated by the following example involving U.S. corporation A which owns 100 percent of the stock of foreign corporation X. A purchased the stock on January 1, 1964, for $100 and sold the stock on January 1, 1966, for $115. For the year 1964, corporation X had earnings and profits, all of which was subpart F income, of $10, which was included in the gross income of A under section 951. Corporation X had no earnings and profits for the year 1965, but made a $5 distribution out of 1964 earnings and profits which was excludable from gross income of A under section 959. For the year 1966, A is required to include $10 in gross income as a long-term capital gain, which amount is computed as follows:

(i) Amount of gain:		
(*a*) Amount realized		$115
(*b*) Adjusted basis:		
Cost	$100	
Increase by amount included in gross income under section 951 (sec. 961(a))	10	
	110	
Reduced by amount excluded from gross income under section 959 (sec. 961(b))	5	
Adjusted basis		105
(*c*) Amount of gain ((*a*) minus (*b*))		10
(ii) Amount of gain includible in gross income of A as a dividend (sec. 1248(a)):		
(*a*) A's proportionate share of earnings and profits accumulated during the period the stock sold was held by A ($10 of earnings and profits for 1964, reduced by $5 distributed in 1965)	$5	
(*b*) A's proportionate share of earnings and profits previously included in the gross income of A under section 951 ($10) reduced by distributions excluded from the gross income of A under sec. 959, ($5)	5	
(*c*) Amount includible in gross income as a dividend ((*a*) minus (*b*))		0
(iii) Amount of gain from the sale of a capital asset held for more than 6 months (item (i) minus item (ii))		10

Paragraph (2) of section 1248(c), for which there is no corresponding provision in the bill as passed by the House, provides that if a foreign corporation realizes gain from the sale or exchange of property in pursuance of a plan of complete liquidation in a taxable year beginning after December 31, 1962, and if section 337(a) would apply if such corporation had been a domestic corporation, the earnings and profits attributable, under regulations prescribed by the Secretary of the Treasury or his delegate, to any net gain from the sale or exchange of property, as defined in section 337(b), will be excluded from earnings and profits of the foreign corporation for purposes of section 1248.

The application of paragraph (2) of section 1248(c) may be illustrated by an example involving foreign corporation X, wholly owned by U.S. person A. Corporation X, reporting its income on a calendar-year basis, adopted a plan of complete liquidation on January 1, 1963. During 1963, it sold all of its assets to M, and realized a gain of $300. The earnings and profits of corporation X for taxable year 1963 were $400, $100 attributable to operations and $300 attributable to the sale of all of its assets to M. Corporation X was completely liquidated

on December 31, 1963, at which time all of its assets were distributed to A. A realized a gain of $500 on the exchange. Corporation X was not a collapsible corporation and section 332 did not apply to the liquidation; $100 of earnings and profits attributable to 1963 operations is includible in the gross income of A as a dividend under the provisions of section 1248(a), and $400 is includible in gross income of A as gain from the exchange of a capital asset.

Paragraph (3) of section 1248(c), for which there is no corresponding provision in the bill as passed by the House, provides for the exclusion from earnings and profits of a foreign corporation, for purposes of section 1248, of earnings and profits accumulated while the foreign corporation was a less developed country corporation, as defined in section 955(c), if the requirements of subparagraphs (A) and (B) are met.

Subparagraph (A) of section 1248(c)(3) provides that the foreign corporation whose stock is sold or exchanged must have qualified (1) as a less developed country corporation, as defined in section 955(c)(1) (added by sec. 13 of the bill), for all taxable years of such corporation beginning after December 31, 1962, for which the country under the laws of which the foreign corporation was created or organized was designated a less developed country under section 955(c)(3) (added by sec. 12 of your committee bill) or (2) as a less developed country corporation, as defined in section 955(c)(2), for all taxable years of such corporation beginning after December 31, 1962, for which the country under the laws of which the aircraft or vessels described in section 955(c)(2) were registered were designated less developed countries under section 955(c)(3).

The application of subparagraph (A) of section 1248(c)(3) may be illustrated by the following examples:

Example 1.—A, a U.S. person, acquired 100 percent of the stock of M, a foreign corporation incorporated under the laws of country X, on January 1, 1951, and sold the stock on December 31, 1965. Corporation M, a calendar year taxpayer, had earnings and profits of $100 in each of its taxable years 1951 through 1965. A realized a gain of $1,900 on the sale of corporation M stock. Country X was designated a less developed country for the year 1963, and corporation M qualified as a less developed country corporation for its 1963 taxable year. A is required to include $200 in gross income as a dividend under the provisions of section 1248(a) ($100 attributable to earnings and profits of taxable year 1964 and $100 attributable to earnings and profits of taxable year 1965). $1,700 of the total gain from the sale of M stock is includible in gross income as long-term capital gain. If foreign corporation X had been designated a less developed country for taxable years 1963 and 1964, but corporation M qualified as a less developed country corporation only for taxable year 1963, $300 of the gain would be includible in gross income of A as a dividend (all post-1962 earnings and profits) and $1,600 would be includible in gross income as long-term capital gain.

Example 2.—A, a U.S. person, owns 100 percent of the stock of foreign corporation M. Corporation M owns 100 percent of the stock of foreign corporation N. Corporation N's only asset in taxable year 1963 is a vessel registered under the laws of foreign country X. Foreign country X was designated a less developed country for taxable year 1963 and corporation N qualified as a less developed country corporation in that year. Corporation M's only income for 1963 was

dividend income from corporation N and corporation N stock constituted the only asset of corporation M for taxable year 1963. Corporation M also qualified as a less developed country corporation for taxable year 1963. Corporation N sold its vessel on December 31, 1963, and purchased a replacement on January 1, 1965. Corporations M and N were not less developed country corporations for taxable year 1964 because Corporation N could not meet the income requirements of section 955(c)(2)(A) for such taxable year. Corporation N registered the vessel acquired January 1, 1965, in foreign country Y which was designated a less developed country for taxable year 1965. Corporations M and N qualified as less developed country corporations for taxable year 1965. A sold the stock in corporation M on December 31, 1965. The earnings and profits of corporation M accumulated in taxable years 1963 and 1965, are excluded from earnings and profits for purposes of section 1248 due to the fact the vessels from which the gross income described in section 955(c)(2) was derived were registered in less developed countries for all taxable years in which corporation N owned the vessels.

Subparagraph (B) of section 1248(c)(3) provides that a U.S. person who sells stock in a foreign corporation described in section 1248(c)(3)(A) must have owned the stock sold or exchanged for a continuous period of at least 10 years ending with the date of sale or exchange. If stock in a foreign corporation is sold by a U.S. person, other than a domestic corporation, such U.S. person must have owned the stock for the entire 10-year period. However, for purposes of subparagraph (B), the holding period of a U.S. person who is an individual, estate, or trust who acquired the stock sold or exchanged by reason of the death of an individual, shall be deemed to include the period the stock was held by the deceased individual, and by any other predecessor in interest if between such individual, estate, or trust, and such other predecessor in interest there was no transfer other than by reason of the death of an individual. If (1) the stock in a foreign corporation is sold by a U.S. person which is a domestic corporation, and (2) more than 50 percent of the total combined voting power of all classes of stock entitled to vote of the domestic corporation was owned at any time during the 10-year period ending on the date of sale or exchange by U.S. persons who were individuals, estates, or trusts, then section 1248(c)(3) will apply only if the same such U.S. persons owned more than 50 percent of the total combined voting power of all classes of stock entitled to vote of the domestic corporation at all times during the remainder of the 10-year period ending on the date of sale or exchange of the stock. However, only U.S. persons, other than domestic corporations, who own, within the meaning of section 958(a), or are considered as owning, by applying the rules of ownership of section 958(b), 10 percent or more of the stock in the domestic corporation which sells the stock in the foreign corporation will be taken into account in determining if 50 percent or more of the stock of the domestic corporation was owned at any time within the 10-year period ending on the date of sale or exchange by individuals, estates, or trusts, and if so held, has been held continuously by the same U.S. persons for the uninterrupted period ending with the date of sale or exchange.

Paragraph (4) of section 1248(c), for which there is no corresponding provision in the bill as passed by the House, provides that the earnings and profits of a foreign corporation, for purposes of section 1248, shall

be determined without regard to any item includible in gross income of the foreign corporation under chapter 1 of the code as income derived from sources within the United States for the period or periods the foreign corporation was engaged in trade or business in the United States. This paragraph will not permit an exclusion in the case of U.S. source income of a controlled foreign corporation having no permanent establishment in the United States in situations (involving tax treaties) in which such permanent establishment is a requisite to imposition of U.S. tax, since in such a situation no amount will have been included in gross income for purposes of this paragraph.

Paragraph (5) of section 1248(c), for which there is no corresponding provision in the bill as passed by the House, correlates section 1248 with section 1247 by providing that the earnings and profits of the foreign corporation, for purposes of section 1248, shall exclude earnings and profits of the foreign corporation for any taxable year of such corporation with respect to which an election under section 1247(a) (added by sec. 14 of the bill) was in effect and for which the U.S. person whose stock is sold or exchanged was a qualified shareholder, as defined in section 1247(c) (added by sec. 14 of the bill).

The application of this paragraph may be illustrated by the following examples:

Example 1.—U.S. person X acquired 10 percent of the stock of foreign corporation A on January 1, 1962, and sold such stock on December 31, 1964. Corporation A, a calendar year taxpayer, was both a controlled foreign corporation, as defined in section 957, and a foreign investment company, as defined in section 1246(b)(1), but was not a foreign personal holding company, as defined in section 552, for taxable years 1962, 1963, and 1964. Corporation A had dividend income of $1,000 and an excess of net long-term capital gain over net short-term capital loss of $500 in each such taxable year (1962, 1963, and 1964). Corporation A made an election in accordance with the provisions of section 1247(a) with respect to taxable years 1963 and 1964 and distributed $900 to its shareholders in both such taxable years. X, by including $140 in gross income ($90 as a dividend and $50 as long-term capital gain) in taxable years 1963 and 1964, was a qualified shareholder, as defined in section 1247(c), for both such years. X realized a gain of $270 on the sale of his stock. Section 1246 does not apply to the sale; but section 1248(a) does apply. However, as applied to the facts of this case, section 1248(c)(5) provides that the earnings and profits, for purposes of section 1248, for taxable years 1963 and 1964 are zero and the entire gain, $270, is includible in gross income of X as long-term capital gain from the sale of a capital asset.

Example 2.—Assume the same facts as in example 1 above except that corporation A was not a foreign investment company as defined in section 1246(b)(1) for taxable year 1964 and X did not include in gross income any amount with respect to the income of corporation A in taxable year 1964. X's ratable share of the earnings and profits of corporation A, as provided by section 1246(a)(1), is includible in gross income of X as gain from the sale of property which is not a capital asset, and section 1248 does not apply because of subsection (d)(3)(B) of section 1248.

(d) *Exceptions.*—Subsection (d) of section 1248, which corresponds to paragraphs (4), (5), and (6) of section 1248(c) of the bill as passed by the House, provides that gain on the sale or exchange of stock in

a foreign corporation shall not be includible in the gross income of the U.S. person if paragraph (1), (2), or (3) applies.

Paragraph (1) provides that section 1248 does not apply to a distribution of property to a U.S. person by a foreign corporation in redemption of part or all of the stock of such corporation to which section 303, relating to distributions in redemption of stock to pay death taxes, applies.

Paragraph (2) provides that section 1248 does not apply to gain recognized because of the receipt of additional consideration on exchanges to which section 356 applies.

Paragraph (3) provides that the amount includible in gross income as a dividend under section 1248(a) shall not include any amount treated as a dividend, as gain from the sale of an asset which is not a capital asset, or as gain from the sale of an asset held for not more than 6 months, under any other provision of the code.

(e) *Taxpayer to establish earnings and profits.*—Subsection (e) of section 1248 is the same as section 1248(d) of the bill as passed by the House, except for conforming and clarifying changes and the addition of a rule applicable to individuals whose Federal income tax is limited under the provisions of section 1248(b)(2).

Subsection (e) of section 1248 provides that the U.S. person selling or exchanging stock in a foreign corporation must establish the amount of earnings and profits of the foreign corporation to be taken into account under subsection (a), and the amount of foreign tax paid by the foreign corporation to be taken into account under subsection (b)(2). If the U.S. person does not establish the amount of earnings and profits to be taken into account, his entire gain will be treated as a dividend under subsection (a). If the U.S. person does not establish the amount of foreign taxes to be taken into account under subsection (b)(2), the limitation of tax of subsection (b)(2) shall not apply.

(b) *Clerical amendment.*—This subsection makes an addition to the table of contents of part IV of subchapter P of chapter 1.

(c) *Effective date.*—This subsection provides that the amendments made by section 15 shall apply with respect to sales or exchanges occurring after December 31, 1962. The bill as passed by the House provided that the amendments made by this section would apply with respect to sales or exchanges occurring after the date of the enactment of the bill.

SECTION 16. SALES AND EXCHANGES OF PATENTS, ETC., TO CERTAIN FOREIGN CORPORATIONS

Section 16 of the bill, for which there is no corresponding provision in the bill as passed by the House, adds a new section 1249 to part IV of subchapter P of chapter 1 (relating to special rules for determining capital gains and losses).

(a) *Treatment of gain as ordinary income.*—Under existing law certain exchanges described in sections 351 and 361 by a taxpayer of a patent or like property to a foreign corporation which the taxpayer controls may result in nonrecognition of gain if, before the exchange, under section 367 it has been established to the satisfaction of the Secretary of the Treasury or his delegate that the exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. However, if the taxpayer fails to

establish that the exchange is not in pursuance of such a plan, or if a transfer by a taxpayer to a foreign corporation which he controls is an exchange other than one described in section 351 or 361, or is a sale, the gain recognized may constitute capital gain.

Subsection (a) of the new section 1249 applies to gain recognized from the sale or exchange after December 31, 1962, of a patent, invention, model, or design (whether or not patented), copyright, secret formula or process, or any similar property right by a U.S. person (as defined in sec. 7701(a)(30)) to a foreign corporation which such person controls. If such gain (but for the new subsection) would be capital gain from the sale or exchange of a capital asset or of property described in section 1231, then it is to be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

Subsection (b) defines control to mean, with respect to a foreign corporation, ownership, directly or indirectly, of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote. The ownership rules of section 958 apply in determining whether control exists.

Subsection (c) provides that subsection (a) does not apply to gain realized from the sale or exchange for stock or contribution to capital of property where it is established to the satisfaction of the Secretary of the Treasury or his delegate that the principal purpose of the transfer is to enable the foreign corporation to use such property in its own manufacturing operations.

(b) *Clerical amendment.*—Subsection (b) of section 16 of the bill makes conforming changes to the table of sections for part IV.

(c) *Effective date.*—Subsection (c) of section 16 of the bill provides that section 1249 applies to taxable years beginning after December 31, 1962.

SECTION 17. TAX TREATMENT OF COOPERATIVES AND PATRONS

(a) *In general.*—Subsection (a) of section 17 of the bill amends the Internal Revenue Code of 1954 by adding to chapter 1 a new subchapter T (relating to cooperatives and their patrons) consisting of part I, tax treatment of cooperatives, part II, tax treatment by patrons of patronage dividends, and part III, definitions and special rules.

Part I—Tax Treatment of Cooperatives

Part I of subchapter T consists of section 1381, organizations to which such part applies, section 1382, taxable income of cooperatives, and section 1383, computation of tax where cooperative redeems nonqualified written notices of allocation.

SECTION 1381. ORGANIZATIONS TO WHICH PART APPLIES

(a) *In general.*—Subsection (a) of section 1381 provides that part I of subchapter T is to apply to any organization which is exempt from tax under section 521 (relating to exemption of farmers' cooperatives) and to any corporation operating on a cooperative basis. Part I is not applicable, however, to any organization (1) which is exempt from income taxes (other than an exempt farmers' cooperative described in

sec. 521); (2) which is subject to the provisions of part II of subchapter H (relating to mutual savings banks, etc.); (3) which is subject to the provisions of subchapter L (relating to insurance companies); or (4) which is engaged in furnishing electric energy, or providing telephone service, to persons in rural areas. Thus, part I of the new subchapter T does not apply to any cooperative exempt from tax under section 501. Nor does it apply to a cooperative which generates or transmits electricity for use by persons living in rural areas.

(b) *Tax on certain farmers' cooperatives.*—Subsection (b) of section 1381 provides that the farmers' cooperatives described in section 521 are subject to corporate income taxes. This is the same provision as the provision presently contained in section 522.

SECTION 1382. TAXABLE INCOME OF COOPERATIVES

(a) *Gross income.*—Subsection (a) of section 1382 provides that, except as provided in section 1382(b), all cooperatives to which part I of the new subchapter T applies must compute gross income without any adjustment (as a reduction in gross receipts, an increase in cost of goods sold, or otherwise) for amounts allocated or distributed to patrons out of net earnings.

(b) *Patronage dividends.*—Subsection (b)(1), applicable to both taxable and exempt cooperatives, provides that in determining the taxable income of a cooperative there are not to be taken into account certain patronage dividends paid in money, qualified written notices of allocation, or other property (other than nonqualified written notices of allocation). Under this subsection, the patronage dividends which are not to be taken into account in computing taxable income for a taxable year are those which are paid during the payment period for that taxable year (as defined in sec. 1382(d)) with respect to patronage occuring during such taxable year. For this purpose, under section 1382(d) a patronage dividend shall be treated as paid in money during the payment period to the extent it is paid by a qualified check (as defined in sec. 1388(c)(4)) issued during the payment period and endorsed and cashed on or before the 90th day after the close of the payment period.

Under subsection (b)(2), also applicable to both taxable and exempt cooperatives, certain amounts paid in money or other property (except written notices of allocation) in redemption of nonqualified written notices of allocation are not to be taken into account in determining the taxable income of a cooperative. The amounts described in subsection (b)(2) which are not to be taken into account for a taxable year are those which are paid during the payment period for that taxable year in redemption of nonqualified written notices of allocation which were paid as patronage dividends during the payment period for the taxable year during which the patronage occurred.

Subsection (b) also provides that amounts described in such subsection which are not taken into account in determining taxable income are to be treated for purposes of the 1954 Code in the same manner as items of gross income and corresponding deductions therefrom. Thus, for example, in determining the amount omitted from gross income for purposes of section 6501(e) (relating to period of limitations where there are omissions from gross income), amounts paid as patronage dividends (though not required to be taken into

account in determining taxable income) are to be treated as amounts properly includible in gross income.

(c) *Deduction for nonpatronage distributions, etc.*—In the case of a farmers' cooperative which is exempt under section 521, certain deductions (in addition to other deductions allowed under ch. 1) are allowed under subsection (c) of the new section 1382. Subsection (c)(1) allows a deduction for dividends paid by such a cooperative during the taxable year on its capital stock. This deduction is the same in substance as that currently allowed under section 522(b)(1)(A).

Subsection (c)(2)(A) allows a deduction for amounts paid (or treated as paid under sec. 1382(d)) during the payment period for a taxable year, on a patronage basis, out of earnings of that taxable year derived either from business done for the United States or from sources other than patronage. A deduction is allowed by subsection (c)(2)(A), however, only for amounts paid in money, qualified written notices of allocation, or other property (except nonqualified written notices of allocation). For purposes of the deduction allowed by subsection (c)(2)(A), amounts are considered as paid on a patronage basis if they are paid in proportion, insofar as is practicable, to the amount of business done by or for patrons during the period to which such amounts are attributable.

In addition to the deductions allowed by subsections (c)(1) and (c)(2)(A), a deduction is allowed under subsection (c)(2)(B) for amounts paid in money or other property (except written notices of allocation) in redemption of a nonqualified written notice of allocation which was previously paid during the payment period for a taxable year on a patronage basis to a patron out of earnings derived during that taxable year either from business done for the United States or from sources other than patronage. A deduction under subsection (c)(2)(B) will be allowed for a taxable year only for amounts paid during the payment period for that taxable year.

For purposes of the new subchapter T, a written notice of allocation is considered paid when it is issued to the patron. Amounts paid in redemption of a nonqualified written notice of allocation which are in excess of the stated dollar amount of such written notice of allocation and which in effect constitute interest may be deducted by the cooperative as interest. These excess amounts will be treated by the distributee as interest and not as a patronage dividend.

(d) *Payment period for each taxable year.*—Subsection (d) of section 1382 contains the definition of the "payment period for each taxable year." It provides that the payment period for any taxable year is the period beginning with the 1st day of such taxable year and ending with the 15th day of the 9th month following the close of such year. Thus, a cooperative has 8½ months after the close of a taxable year in which to pay patronage dividends out of the net earnings from patronage occurring during that taxable year. Any patronage dividend which it pays after that time must be taken into account by the cooperative in computing its taxable income; and the cooperative will be allowed no subsequent adjustment for any amount it pays in redemption of a written notice of allocation which was paid as a part of such patronage dividend. The same general rules apply with respect to nonpatronage distributions made on a patronage basis. Subsection (d) also provides that, for purposes of section 1382 (b)(1) and (c)(2)(A), a qualified check shall be treated as an amount paid in money during the payment period for a taxable year if it is issued during such

payment period and is endorsed and cashed on or before the 90th day after the close of such payment period.

(e) *Products marketed under pooling arrangements.*—Subsection (e) of section 1382 provides a special rule for determining, for purposes of section 1382(b), when the patronage is considered to have occurred in the case of a pooling arrangement for the marketing of products. Under this rule, the patronage will (to the extent provided in regulations prescribed by the Secretary of the Treasury or his delegate) be treated as occurring during the taxable year in which the pool closes. For example, farmer A delivers to the X cooperative 100 bushels of wheat on August 15, 1963, at which time he receives a "per bushel" advance. On October 15, 1963, he receives an additional "per bushel" payment. The pool sells some of its wheat in 1963 and the rest in January of 1964. The pool is closed on February 15, 1964. For purposes of section 1382(b), A's patronage is considered as occurring in 1964.

Section 1382 has no effect on, and is not intended to change, existing rules with respect to the time at which items are taken into account in computing the cooperative's gross income. For example, a tobacco stabilization cooperative may be required by the Commodity Credit Corporation to apply a portion of its proceeds from the sale of tobacco against loans on other crop years. In a letter to the Department of Agriculture dated October 11, 1955, the Internal Revenue Service held that this portion of the proceeds was not includible in the cooperative's gross income until the cooperative had an unrestricted right to such portion. Section 1382 will in no way change this holding. Under section 1382(f), the Secretary of the Treasury or his delegate may provide by regulations that, in such a case, the patronage to which this portion of the proceeds relates is to be considered to have occurred during the taxable year when the cooperative first had an unrestricted right to such portion. This will permit the cooperative to pay these proceeds out as patronage dividends during the payment period for such later year. If the conditions of section 1382(b) are met, such patronage dividends need not be taken into account in determining the taxable income of the cooperative for such later year. Section 1382(f) permits the Secretary of the Treasury or his delegate to provide similar rules as to when patronage is considered to have occurred in other cases when earnings are includible in the gross income of a cooperative for a taxable year after the patronage occurred.

SECTION 1383. COMPUTATION OF TAX WHERE COOPERATIVE REDEEMS NONQUALIFIED WRITTEN NOTICES OF ALLOCATION

Section 1383 provides a special rule for computing a cooperative's tax for a year when it redeems nonqualified written notices of allocation.

(a) *General rule.*—Section 1383(a) provides that if, for a taxable year, a cooperative is allowed a deduction under section 1382 (b)(2) or (c)(2)(B) for amounts it pays in redemption of nonqualified written notices of allocation, then its tax for that year shall be whichever of the following is the smaller:

(1) The tax for the taxable year computed with the deduction for the amounts paid in redemption of the nonqualified written notices of allocation, or

(2) An amount equal to—

(A) the tax for the taxable year computed without such deduction, minus

(B) the decrease in tax under chapter 1 for the prior taxable year (or years) which would result solely from treating such nonqualified written notices of allocation as qualified written notices of allocation.

(b) *Special rules.*—Section 1383(b) provides three special rules applying to the alternative tax computations based on the decrease in tax for the prior taxable years. Under section 1383(b)(1), if the decrease in tax for the prior taxable year (or years) exceeds the tax for the current year (computed without any deduction for amounts paid in redemption of nonqualified written notices of allocation), the excess is to be considered to be a payment of tax on the last day prescribed by law for the payment of tax for the current taxable year, and is to be refunded or credited in the same manner as if it were an overpayment for the current taxable year.

Section 1383(b)(2) provides that, for purposes of computing the decrease in tax for the prior taxable year, the nonqualified written notices of allocation which are treated as qualified written notices of allocation are to be considered to have a stated dollar amount equal to the amount paid in redemption of such written notices of allocation to the extent such amount is allowable as a deduction under section 1382 (b)(2) or (c)(2)(B).

Section 1383(b)(3) provides that if the alternative tax computation provided by section 1383(a)(2) is used, then the deduction otherwise allowable for the current year by reason of the redemption of nonqualified written notices of allocation is not to be allowed for any purpose under the 1954 Code.

The application of section 1383 may be illustrated by the following example:

The X cooperative (which reports its income on a calendar year basis) pays patronage dividends of $100 in nonqualified written notices of allocation on February 1, 1964, with respect to patronage occurring in 1963. Since the patronage dividends were paid in nonqualified written notices of allocation, the X cooperative must include the $100 in gross income and is not allowed a deduction for that amount for 1963. On December 1, 1966, the X cooperative redeems these nonqualified written notices of allocation for $50. Section 1382(b)(2) permits, in effect, the X cooperative to deduct that $50 from gross income in determining its taxable income for 1966. However, if the X cooperative otherwise has a loss for 1966 and, therefore, owes no tax for that year, it may make the computation under the alternative method provided in section 1383(a)(2). Under this alternative, it would be permitted a credit or refund of the decrease in tax for 1963 which results from recomputing the 1963 tax liability as if patronage dividends of $50 had been paid for 1963 in qualified written notices of allocation. If this alternative is used, the X cooperative cannot then use the $50 deduction otherwise allowable for 1966 to increase its net operating loss carryback or carryforward. If the X cooperative also redeems on December 1, 1966, nonqualified written notices of allocation which were paid as patronage dividends on February 1, 1965, with respect to patronage occurring in 1964, it would be allowed a credit or refund for the decrease in tax for 1964. It could not, however, apply one method for computing the tax with

respect to the redemption in 1966 of the nonqualified written notices of allocation paid in 1964 and the other method with respect to the redemption in 1966 of the nonqualified written notices of allocation paid in 1965.

Part II—Tax Treatment by Patrons of Patronage Dividends

Part II of subchapter T, consisting of section 1385, deals with the patron's tax treatment of patronage dividends and amounts paid by an exempt farmers' cooperative from nonpatronage earnings.

SECTION 1385. AMOUNTS INCLUDIBLE IN PATRON'S GROSS INCOME

(a) *General rule.*—Subsection (a)(1) requires the patron to include in gross income the amount of any patronage dividend (other than one described in sec. 1385(b)) received during the taxable year from a taxable or an exempt cooperative to which part I of subchapter T applies, if paid in money, a qualified written notice of allocation, or other property (except a nonqualified written notice of allocation). Subsection (a)(2) requires inclusion in the gross income of the patron of distributions (other than those paid in nonqualified written notices of allocation) paid on a patronage basis by a farmers' cooperative exempt under section 521 with respect to earnings derived either from business done for the United States or from sources other than patronage. The patron must include patronage dividends in gross income for the taxable year during which they are received, even though the adjustment in computing taxable income of the cooperative was made for its preceding taxable year because they were paid during the payment period for such preceding taxable year. Patronage dividends are includible in the patron's gross income under section 1385 even if the cooperative is not permitted any adjustment for such patronage dividends because they were not paid during the payment period for the taxable year in which the patronage occurred.

(b) *Exclusion from gross income.*—Subsection (b)(1) of section 1385 excludes from gross income a patronage dividend, or an amount received on the redemption, sale, or other disposition of a nonqualified written notice of allocation which was previously paid as a patronage dividend, which is properly taken into account as an adjustment to basis of property. For example, if a patronage dividend is attributable to the purchase of a capital asset or property used in a trade or business, such patronage dividend will not be included in the distributee's gross income but will reduce the basis of such asset or property. Subsection (b)(2) provides that a patronage dividend, or an amount received on the redemption, sale, or other disposition of a nonqualified written notice of allocation which was previously paid as a patronage dividend, which is paid to a patron with respect to the purchase of a personal, rather than a business, expense item, is not includible in gross income. These provisions are to be applied under regulations prescribed by the Secretary of the Treasury or his delegate.

(c) *Treatment of certain nonqualified written notices of allocation.*—Subsection (c)(1) of section 1385 describes the kind of nonqualified written notices of allocation to which section 1385(c) applies. This subsection applies to a nonqualified written notice of allocation which was paid as a patronage dividend by a taxable or an exempt coopera-

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tive, and to a nonqualified written notice of allocation which was paid on a patronage basis by a farmers' cooperative exempt under section 521 out of earnings derived either from business done for the United States or from sources other than patronage.

Subsection (c)(2)(A) of section 1385 provides that such a nonqualified written notice of allocation is to have a zero basis in the hands of the patron to whom it was paid. Subsection (c)(2)(B) of section 1385 provides that the basis of a nonqualified written notice of allocation described in subsection (c)(1) acquired from a decedent is to be its basis in the hands of the decedent. Any amount which the beneficiary is required to report as ordinary income on the redemption, sale, or other disposition of such written notice of allocation is income in respect of a decedent under section 691 of the code. Subsection (c)(2)(C) provides that any gain on the redemption, sale, or other disposition of a nonqualified written notice of allocation described in subsection (c)(1) is to be ordinary income to the extent that its stated dollar amount exceeds its basis. This is true whether such gain is realized by the patron who received the nonqualified written notice of allocation or any subsequent holder. For example, farmer A receives a patronage dividend paid in the form of a nonqualified written notice of allocation which is attributable to the sale of his crop to the X cooperative. The stated dollar amount of the nonqualified written notice of allocation is $100. The basis of the written notice of allocation in the hands of farmer A is zero and he must report any amount up to $100 received by him on its redemption, sale, or other disposition as ordinary income. If farmer A gives the written notice of allocation to his son B, B takes farmer A's (the donor's) basis which is zero, and any gain up to $100 which B later realizes on its redemption, sale, or other disposition is ordinary income. Similarly, if A dies before realizing any gain on the nonqualified written notice of allocation, B, his legatee, has a zero basis for such written notice of allocation and any gain up to $100 which he then realizes on its redemption, sale, or other disposition is also ordinary income. Any amounts realized on the redemption, sale, or other disposition of such nonqualified written notice of allocation in excess of $100 will be treated under the applicable provisions of the code. These provisions in section 1385(c)(2)(C) are not intended to reflect in any way on how gain on the redemption, sale, or other disposition of a written notice of allocation would be treated under existing law.

Part III—Definitions; Special Rules

Part III of subchapter T, consisting of section 1388, defines "patronage dividend," "written notice of allocation," "qualified written notice of allocation," "qualified check," and "nonqualified written notice of allocation," and provides special rules for determining amounts paid or received.

SECTION 1388. DEFINITIONS; SPECIAL RULES

(a) *Patronage dividend.*—Under subsection (a) of section 1388, the term "patronage dividend" means an amount paid to a patron by a cooperative to which part I of subchapter T applies (1) on the basis of quantity or value of business done with or for such patron, (2) under an obligation to pay such amount, which obligation existed before the

cooperative received the amount, and (3) which is determined by reference to the net earnings of the cooperative from business done with or for its patrons. It is made clear that there are not to be included as patronage dividends any amounts which are out of earnings other than from business done with or for patrons, or any amounts paid to patrons which are attributable to the patronage of other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions. Thus, if a cooperative does not pay any patronage dividends to nonmembers, any portion of the amounts paid to members which is out of net earnings from patronage with nonmembers, and which would have been paid to the nonmembers if all patrons were treated alike, is not a patronage dividend.

(b) *Written notice of allocation.*—The term "written notice of allocation" is defined in subsection (b) of section 1388 to mean any capital stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice, which discloses to the recipient the stated dollar amount allocated to him, and the portion thereof, if any, which constitutes a patronage dividend.

This definition is applicable both to written notices of allocation paid as patronage dividends and to written notices of allocation paid with respect to nonpatronage earnings or earnings from business done for the United States.

(c) *Qualified written notice of allocation.*—Subsection (c)(1) of section 1388 contains the definition of "qualified written notice of allocation". Subsection (c)(1)(A) provides, in the case of both taxable and exempt cooperatives, that the term "qualified written notice of allocation" includes a written notice of allocation which the patron may redeem in cash, at its stated dollar amount, at any time within a period beginning on the date such written notice of allocation is paid and ending not earlier than 90 days from such date. The patron must be notified by the cooperative, in writing, at the time he receives the written notice of allocation, of this right of redemption. It is intended that this notice must be given separately to each patron and not in the form of a notice in a newspaper or posted at the cooperative's headquarters. If the patron does not exercise his option to redeem the written notice of allocation, he must, nevertheless, take it into account, at its stated dollar amount, in the manner provided in section 1385(a).

Subsection (c)(1)(B) of section 1388, also applicable to both taxable and exempt cooperatives, provides that the term "qualified written notice of allocation" also includes a written notice of allocation which the patron has consented to take into account at its stated dollar amount in the manner provided in section 1385(a). This consent must be made in the manner provided in subsection (c)(2) of section 1388.

Subsection (c)(1) provides, however, that a written notice of allocation is not "qualified" unless at least 20 percent of the patronage dividend, or the payment with respect to nonpatronage earnings or earnings from business done for the United States, of which it is a part, is paid in money or by qualified check (as defined in sec. 1388(c)(4)). Thus, even though the patron has consented to take the face amount of a written notice of allocation paid as part of a patronage dividend into account as provided in section 1385(a), or

such allocation is redeemable for cash at any time within a period of at least 90 days, such written notice of allocation will not be qualified unless at least 20 percent of the patronage dividend is paid in money or by qualified check.

Subsection (c)(2) of section 1388 provides the three different ways in which the consent to take written notices of allocation into account as provided in section 1385(a) may be made. The first way is to make such consent in writing. (This does not include a consent made by endorsing and cashing a qualified check which is described in subsection (c)(2)(C).) The written consent must be made by the patron before the close of the cooperative's taxable year during which the patronage to which the written notice of allocation is attributable occurred. Such consent is, under subsection (c)(3)(A)(i), effective with respect to all patronage occurring during the taxable year of the cooperative in which such consent is made and, unless revoked as provided in subsection (c)(3)(B)(i), all subsequent taxable years. Subsection (c)(3)(B)(i) provides that such a consent may be revoked by the patron at any time. The revocation must be in writing and filed with the cooperative. Thus, any such written consent which is, by its terms, irrevocable is not a consent that would qualify a written notice of allocation under subsection (c)(1)(B). A revocation is only effective with respect to patronage occurring after the close of the cooperative's taxable year during which the revocation is filed with it. In the case of a patron participating in a pooling arrangement described in section 1382(e), a written consent may be made at any time before the close of the cooperative's taxable year during which the pool closes. Any subsequent revocation filed by the patron, however, would not be effective with respect to that pool.

Subsection (c)(2)(B) describes another way the consent can be given by a patron who is a member (or prospective member) of the cooperative. In this case, the consent may be made by the patron by obtaining or retaining membership in the cooperative after--

(A) the cooperative has adopted a bylaw providing that membership in the cooperative constitutes such consent, and

(B) he has received a written notification and copy of such bylaw.

The bylaw described in (A) must be adopted by the cooperative after the date of enactment of this bill (the Revenue Act of 1962) and must contain a clear statement that membership in the cooperative constitutes the prescribed consent. The following is an example of a bylaw provision which would meet this requirement:

> Each person who hereafter applies for and is accepted to membership in this cooperative and each member of this cooperative on the effective date of this bylaw who continues as a member after such date shall, by such act alone, consent that the amount of any distributions with respect to his patronage occurring after ----------, which are made in written notices of allocation (as defined in 26 U.S.C. 1388) and which are received by him from the cooperative, will be taken into account by him at their stated dollar amounts in the manner provided in 26 U.S.C. 1385(a) in the taxable year in which such written notices of allocation are received by him.

Before a patron shall be considered to have consented under this second alternative, he must receive the written notification and the copy of the bylaw, as provided in (B) above. In the case of a new member, he must receive the notification and the copy of the bylaw before he becomes a member. The written notification must inform the patron that this bylaw has been adopted and of its significance. It is intended that the notification and copy of the bylaw must be given to each individual separately and not in the form of a notice in a newspaper or posted at the cooperative's headquarters.

Under subsection (c)(3)(A)(ii) of section 1388, this alternative consent will be effective with respect to all patronage of the member-patron occurring after he receives the notification and copy of the bylaw provision. In the case of a pooling arrangement described in section 1382(e), the consent will only be effective with respect to the member's actual patronage occurring after he receives the notification and copy of the bylaw and shall not be effective with respect to any of his patronage under the pool before this time. Subsection (c)(3)(B)(ii) provides that this alternative consent will not apply to any patronage of the patron after he ceases to be a member of the cooperative or after the bylaw provision is repealed by the cooperative. In the case of a pooling arrangement, this refers to the time when the patronage actually occurred. Thus, if the patron resigns his membership in the cooperative during the period a pool is in operation, he will not be considered to have consented with respect to any of his patronage under the pool after the date of his resignation.

Subsection (c)(2)(C) describes the third way that a patron may consent to take a written notice of allocation into account as provided in section 1385(a). Under this alternative, the consent may be given by endorsing and cashing a qualified check (as defined in subsec. (c)(4)) which is paid as part of the same patronage dividend, or the same distribution with respect to nonpatronage earnings, as is the written notice of allocation.

Subsection (c)(4) defines a qualified check to mean only a check, or other instrument redeemable in money, (1) which is paid as a part of a patronage dividend, or as a part of a payment described in section 1382(c)(2)(A), to a patron who has not already given consent in the manner provided in subsection (c)(2) (A) or (B) with respect to such patronage dividend or such payment, and (2) on which there is clearly imprinted a statement that the endorsement and cashing of the check (or other instrument) constitutes the consent of the payee to take into account, as provided in the Federal income tax laws, the stated dollar amount of any written notices of allocation which are paid as a part of the patronage dividend or payment of which such check (or other instrument) is also a part. The term "qualified check" does not include a check or other instrument which is paid as part of a patronage dividend or payment which does not include a written notice of allocation (other than one described in sec. 1388(c)(1)(A)). Thus a check which is paid as part of a patronage dividend is not a "qualified check" (even though it has the above-described statement imprinted on it) if the remaining portion of such patronage dividend is paid in cash or if the only written notices of allocation included in the distribution are redeemable allocations which are considered qualified under section 1388(c)(1)(A). Under this definition, it is not necessary that a qualified check be in the form of an ordinary check which is payable through

the banking system. It may, for example, be in the form of an instrument which may be redeemed by the cooperative for money.

In order to constitute consent, a qualified check must be cashed by the payee on or before the 90th day after the close of the payment period for the taxable year of the cooperative for which the patronage dividend, or the distribution with respect to nonpatronage earnings, is paid. Thus, in the case of a cooperative on a calendar year basis, which pays patronage dividends for 1963 in qualified checks and written notices of allocation, only those patrons who cash their qualified checks on or before December 14, 1964, shall be considered to have consented under subsection (c)(2)(C) with respect to the written notices of allocation. For purposes of determining whether or not the cooperative is required to take the amount of a qualified check into account in computing its taxable income under section 1382 (b)(1) or (c)(2)(A), section 1382(d) provides that those qualified checks which are issued during the payment period for the taxable year and which are endorsed and cashed on or before the 90th day after the close of such period shall be treated as amounts paid in money during such payment period. Thus, in the above example, if the qualified checks were issued on or before September 15, 1964, then the amount of those checks which are cashed on or before December 14, 1964, shall be treated, for purposes of section 1382(b)(1), as patronage dividends paid in money during the payment period for 1963.

Under the above example, in the case of a patron who has not cashed his qualified check by December 14, 1964, there is no consent and both the written notice of allocation and the qualified check constitute nonqualified written notices of allocation. Therefore, as of that date, the patron is not required to include any amount in gross income, and the cooperative is allowed no deduction, with respect to either the qualified check or the written notice of allocation. If the payee cashes his check on January 2, 1965, he shall treat the amount received for tax purposes as an amount received on January 2, 1965, in redemption of a nonqualified written notice of allocation. Likewise, the cooperative shall treat the amount of the check as an amount paid on January 2, 1965, in redemption of a nonqualified written notice of allocation. The written notice of allocation itself will be treated in the same manner as any other nonqualified written notice of allocation; that is, nothing will be includible in the gross income of the patron and no deduction will be allowed the cooperative until the written notice of allocation is redeemed.

Since the term "qualified check" includes only checks or other instruments issued to patrons who have not otherwise consented with respect to the distribution of which the check or other instrument is a part, the endorsing and cashing of a check which contains a statement that this constitutes consent by a patron of a cooperative shall have no effect as a consent if such patron is already considered as having consented by reason of subsection (c)(2) (A) or (B) with respect to the distribution of which such check is a part.

Endorsing and cashing a qualified check shall be considered a consent only with respect to the written notices of allocation which are paid as part of the same distribution as is the qualified check.

(d) *Nonqualified written notice of allocation.*—Subsection (d) of section 1388 defines "nonqualified written notice of allocation" to mean (1) a written notice of allocation which is not described in subsection (c) and (2) a qualified check which is not cashed on or before

the close of the 90th day after the close of the payment period for the taxable year (of the cooperative) for which the distribution of which it is a part is paid.

(e) *Determination of amount paid or received.*—Subsection (e) of section 1388 provides that, for purposes of the new subchapter T, in determining amounts paid or received: (1) Property, other than a written notice of allocation, is to be taken into account at its fair market value, and (2) a qualified written notice of allocation is to be taken into account at its stated dollar amount. Thus, if a cooperative pays part of its patronage dividends in qualified written notices of allocation, and the requirements of section 1382 are met, the cooperative will not be required to take the stated dollar amounts of such written notices of allocation into account in determining its taxable income. Conversely, the patron receiving a qualified written notice of allocation must take it into account, as provided in section 1385(a), at its stated dollar amount. If a cooperative pays a patronage dividend in nonqualified written notices of allocation, it is required to include the stated dollar amount thereof in gross income and is allowed no deduction (and the patrons are not required to include such amount in gross income) at the time such written notices of allocation are paid (or received).

SECTION 17. TAX TREATMENT OF COOPERATIVES AND PATRONS (Continued)

(b) *Technical amendments.*—Subsection (b) of section 17 of the bill makes certain technical amendments to reflect the provisions of the new subchapter T.

Paragraph (1) amends section 521(a) (relating to exemption of farmers' cooperatives from tax) to insert references to part I of the new subchapter T.

Paragraph (2) repeals section 522 (relating to tax on farmers' cooperatives exempt under sec. 521).

Paragraph (3) amends section 6072(d) (relating to time for filing income tax returns of exempt cooperative associations) to extend the time for filing income tax returns of certain taxable cooperatives. Under this amendment, these cooperatives need not file returns for a taxable year until the 15th day of the 9th month following the close of such taxable year. Under existing law, these nonexempt cooperatives must file returns for a taxable year on or before the 15th day of the 3d month following the close of such taxable year. The taxable cooperatives which may take advantage of this filing date provision are those described in section 1381(a)(2) which either (1) are under an obligation to pay patronage dividends in an amount equal to 50 percent or more of net earnings from business done with or for patrons, or (2) actually paid patronage dividends in such an amount out of net earnings from business done with or for patrons during the most recent taxable year for which they had such net earnings. Under existing law, exempt farmers' cooperatives are not required to file returns for a taxable year until the 15th day of the 9th month following the close of such taxable year, and this rule is not changed.

(c) *Effective dates.*—Subsection (c) of section 17 of the bill prescribes the effective dates for subsections (a) and (b).

Paragraph (1) of subsection (c) provides that, in the case of cooperatives, the amendments made by subsections (a) and (b) will, ex-

cept as provided in paragraph (3), apply to taxable years of organizations described in section 1381(a) beginning after December 31, 1962.

Paragraph (2) of subsection (c) provides that, in the case of patrons, section 1385 will, except as provided in paragraph (3), apply with respect to any amount received from any organization described in section 1381(a), to the extent that such amount is paid by such organization in a taxable year of such organization beginning after December 31, 1962.

Paragraph (3) of subsection (c) provides that, in the case of any money, written notices of allocation, or other property, paid by any organization described in section 1381(a)—

(A) before the first day of the first taxable year of such organization beginning after December 31, 1962, or

(B) on or after such first day with respect to patronage occurring before such first day,

the tax treatment of such money, written notices of allocation, or other property (including the tax treatment of gain or loss on the redemption, sale, or other disposition of such written notices of allocation) by any cooperative or patron is to be made under the 1954 Code without regard to the new subchapter T. For example, if a cooperative pays a patronage dividend during its taxable year beginning January 1, 1963, out of net earnings for its taxable year ending on December 31, 1962, the tax treatment of such a patronage dividend (including the determination of when it is considered paid) would be determined under existing law. Furthermore, the provisions of section 1382 (b)(2) and (c)(2)(B) (relating to deduction for amounts paid in redemption of certain nonqualified written notices of allocation) and section 1383 (relating to computation of tax where a cooperative redeems nonqualified written notices of allocation) are not applicable to amounts paid in redemption of a written notice of allocation which was paid (whether before or after January 1, 1963) with respect to patronage occurring before such date.

SECTION 18. INCLUSION OF FOREIGN REAL PROPERTY IN GROSS ESTATE

This section of the bill is the same as section 18 of the bill as passed by the House, except that the special provisions discussed below in subsection (b), which under the bill as passed by the House were applicable in the case of decedents dying after the date of enactment and before July 1, 1964, are changed by your committee so as to be applicable in the case of decedents dying after the date of enactment and before January 1, 1963.

(a) *Amendments to include foreign real property.*—Subsection (a) of section 18 of the bill amends sections 2031(a), 2033, 2034, 2035(a), 2036(a), 2037(a), 2038(a), 2040, and 2041(a) of the 1954 Code by striking from each section the language which requires the exclusion from the gross estate of real property situated outside of the United States. The result of these amendments, subject to the effective date provisions of subsection (b) of section 18, is to include in the gross estate of decedents who are citizens or residents of the United States, the fair market value of their interest in real property which is situated outside of the United States. Under existing law real

property situated outside of the United States is excluded in determining the value of the gross estate.

(b) *Effective date.*—Subsection (b) of section 18 provides that the amendments which repeal the exclusion for real property situated outside of the United States are effective with respect to the estates of decedents dying after the date of the enactment of the bill. However, special provisions apply in the case of decedents dying after such date of enactment and before January 1, 1963.

Under one of these provisions, the value of real property situated outside of the United States is not included in the gross estate of the decedent under section 2033, 2034, 2035(a), 2036(a), 2037(a), or 2038(a) to the extent the decedent's interest in it was acquired before February 1, 1962. Under another of these special provisions, the value of real property situated outside the United States is excluded from the gross estate of a decedent who dies after the date of the enactment of the bill and before January 1, 1963, to the extent the property or interest therein was either held by the decedent and the surviving tenant in a joint tenancy or tenancy by the entirety before February 1, 1962, or, even though the joint tenancy or tenancy by the entirety was created on or after February 1, 1962, to the extent the property or interest therein was acquired by the decedent before February 1, 1962. Under still another of these special provisions, in the case of decedents dying after the date of the enactment of the bill and before January 1, 1963, the value of real property situated outside the United States is excluded from the gross estate to the extent that before February 1, 1962, it was subject to a general power of appointment possessed by the decedent.

For purposes of applying these three special provisions, the real property, interests therein, and general powers of appointment to which these special provisions apply, which are acquired by the decedent after January 31, 1962, by gift within the meaning of section 2511, or from a prior decedent by devise or inheritance, or by reason of death, form of ownership, or other conditions (including the exercise or nonexercise of a power of appointment), are treated as acquired before February 1, 1962, if the donor or prior decedent acquired the property, his interest therein, or a power of appointment (whether or not a general power) in respect thereof, before that date. For example, assume that A, who bought foreign real property on December 1, 1961, dies on March 1, 1962, and by will leaves the property to B who dies after the date of the enactment of the bill and before January 1, 1963. In this example B will be treated as having acquired the property before February 1, 1962, since A, the prior decedent from whom B acquired the property, had acquired it before February 1, 1962.

For purposes of the amendments made by section 18(b) of the bill, substantial capital additions and improvements to real property made after January 31, 1962, are to be treated as separate properties. Capital additions or improvements to either commercial or residential property which do not materially increase the value of the property are to be disregarded.

SECTION 19. REPORTING OF INTEREST, DIVIDEND, AND PATRONAGE DIVIDEND PAYMENTS OF $10 OR MORE DURING A YEAR

Section 19 of the bill as passed by the House provided a system for the withholding of tax at the source on interest, dividends, and patronage dividends. Your committee has struck out those provisions and has inserted provisions which would require annual information reporting of certain dividend, interest, or patronage dividend payments. Such reporting is to be required with respect to payments to any person when they aggregate $10 or more in amount to such person in any calendar year. In addition, your committee has added provisions requiring that payers of interest, dividends, or patronage dividends furnish to the recipients of these amounts annual statements showing the amounts paid to them as reported on the information returns filed with the Government. New penalty provisions are provided by your committee for failure to file information returns with respect to payments of interest, dividends, or patronage dividends and for failure to furnish to a recipient of such payments an annual statement of such payments.

(a) *Returns regarding payment of dividends and corporate earnings and profits.*—Subsection (a) of the new section 19 completely revises section 6042 of the 1954 Code (relating to returns regarding corporate dividends, earnings, and profits). Under existing section 6042 of the code the Secretary of the Treasury or his delegate has discretionary authority to require corporations to make information returns, with respect to their payments of dividends, showing the name and address of, the number of shares owned by, and the amount of dividends paid to, each shareholder. In addition, the Secretary of the Treasury or his delegate may require corporations to furnish other specified information, such as statements of accumulated earnings and profits, the names and addresses of shareholders who would be entitled to such earnings and profits if they were distributed, and the amounts that would be payable to each.

SECTION 6042. RETURNS REGARDING PAYMENT OF DIVIDENDS AND CORPORATE EARNINGS AND PROFITS

(a) *Requirement of reporting.*—Subsection (a)(1) of the new section 6042 requires every person making payments of dividends aggregating $10 or more to any other person during any calendar year to file an information return with respect to such payments. In addition, such new subsection requires persons receiving payments of dividends in the capacity of nominee to report payments by them aggregating $10 or more during any calendar year to any other person with respect to the dividends so received. Thus, if an individual has his stock registered in the name of his stockbroker, the stockbroker must file an information return showing the name and address of the individual and the amount of dividends he received and paid over to, or credited to the account of, such individual during the calendar year if they amount to $10 or more. The return to be filed under section 6042(a)(1) is to be made according to the forms or regulations prescribed by the Secretary of the Treasury or his delegate and is

to set forth the name and address of the person to whom the payments were made and the aggregate amount of such payments.

Section 6042 only requires reporting with respect to dividends paid by one "person" to another "person." For purposes of this section (and secs. 6044, as amended by the bill, and 6048, as added by the bill) the term "person" has the meaning assigned to it by section 7701(a)(1) of the code. Under that section the term "person" does not include the United States, a State, a foreign government, a political subdivision of a State or foreign government, or an international organization. Therefore, dividends (and patronage dividends and interest) paid by or to one of these entities need not be reported. The person required to report under subsection (a)(1) is the person on whose capital stock the dividends are paid. The term "payment" includes constructive payment. Thus, dividends which are credited to the account of a shareholder by a mutual fund must be reported by the fund if they aggregate $10 or more during the calendar year. The term "nominee" does not include a partner acting with respect to property of a partnership of which he is a member or a person who, acting in the capacity of trustee, holds record title to trust property. The general rules discussed in this paragraph are also applicable with respect to the new reporting requirements for interest and patronage dividends.

Subsection (a)(2) of the new section 6042 gives the Secretary of the Treasury or his delegate discretion to require information returns to be filed with respect to dividend payments aggregating less than $10 during a calendar year.

(b) *Dividend defined.*—Subsection (b)(1) of the new section 6042 defines the term "dividend" for purposes of section 6042 to mean: (A) any distribution by a corporation which is a dividend as defined in section 316 of the code; and (B) any payment made by a stockbroker to any person as a substitute for a dividend (as so defined). Reporting is required whether a dividend is paid in cash or in other property. A dividend paid by an insurance company to a policyholder, other than a dividend upon the capital stock of such insurance company, is not a dividend within the meaning of section 6042(b)(1).

Subsection (b)(2) of the new section 6042 provides that the term "dividend," for purposes of section 6042, does not include: (A) to the extent provided in regulations prescribed by the Secretary of the Treasury or his delegate, any distribution or payment (i) by a foreign corporation, or (ii) to a foreign corporation, a nonresident alien, or a partnership not engaged in trade or business in the United States and composed in whole or in part of nonresident aliens; or (B) any amount described in section 1373 of the code (relating to undistributed taxable income of electing small business corporations).

Subsection (b)(3) provides that if the person making any payment described in subsection (a)(1) is unable to determine the portion of the payment which is a dividend or is paid with respect to a dividend, the total amount of the payment is to be treated as a dividend for purposes of information reporting required by subsection (a)(1). Thus, if a corporation is unable to determine what portion of its distributions to its shareholders during the calendar year is paid out of earnings and profits, the total amount of the distributions must be treated as a dividend.

(c) *Statements to be furnished to persons with respect to whom information is furnished.*—Subsection (c) of the new section 6042 requires every person making a return under subsection (a)(1) of section 6042 to furnish to each person whose name is set forth in such return a written statement showing (1) the name and address of the person making the return, and (2) the aggregate amount paid to the person as shown on the return. Such written statement is to be furnished to the person on or before January 31 of the year following the calendar year for which the return was made. However, no statement is required to be furnished to any person under this subsection if the aggregate amount of payments to the person as shown on the return made under subsection (a)(1) is less than $10.

(d) *Statements to be furnished by corporations to Secretary.*—Subsection (d) of the new section 6042 provides that every corporation shall, when required by the Secretary of the Treasury or his delegate—

(1) furnish to the Secretary of the Treasury or his delegate a statement stating the name and address of each shareholder, and the number of shares owned by each shareholder;

(2) furnish to the Secretary of the Treasury or his delegate a statement of such facts as will enable him to determine the portion of the earnings and profits of the corporation (including gains, profits, and income not taxed) accumulated during such periods as the Secretary of the Treasury or his delegate may specify, which have been distributed or ordered to be distributed, respectively, to its shareholders during such taxable years as the Secretary of the Treasury or his delegate may specify; and

(3) furnish to the Secretary of the Treasury or his delegate a statement of its accumulated earnings and profits and the names and addresses of the individuals or shareholders who would be entitled to such accumulated earnings and profits if divided or distributed, and of the amounts that would be payable to each.

These provisions are substantially the same as provisions contained in the present section 6042.

SECTION 19. REPORTING OF INTEREST, DIVIDEND, AND PATRONAGE DIVIDEND PAYMENTS OF $10 OR MORE DURING A YEAR (Continued)

(b) *Returns regarding payments of patronage dividends.*—Subsection (b) of the new section 19 amends section 6044 of the 1954 Code, to revise the provisions relating to information returns which must be filed by cooperatives.

Under existing law, a cooperative must file an information return with respect to patronage dividends which it pays to a patron during a calendar year if the aggregate is $100 or more. Existing law also gives the Secretary of the Treasury or his delegate authority to require such information returns with regard to all patronage dividends regardless of amounts. The revised section 6044 requires reporting with respect to all payments of $10 or more during the calendar year and, in addition, reflects the provisions of the new subchapter T of chapter 1 (relating to the tax treatment of cooperatives and patrons) which is added to the code by section 17 of the bill.

SECTION 6044. RETURNS REGARDING PATRONAGE DIVIDENDS

(a) *Requirement of reporting.*—Subsection (a)(1) provides that, except as otherwise provided in section 6044, every cooperative to which part I of subchapter T of chapter 1 applies, which makes payments of amounts described in subsection (b) aggregating $10 or more to any person during any calendar year, is to file an information return with respect to such payments. Such return is to be made according to the forms or regulations prescribed by the Secretary of the Treasury or his delegate and is to set forth the aggregate amount of the payments and the name and address of the person to whom paid.

Subsection (a)(2) provides that the Secretary of the Treasury or his delegate may require information returns regarding payments of amounts described in subsection (b) where such payments aggregate less than $10 to any person during any calendar year.

(b) *Amounts subject to reporting.*—Subsection (b)(1) provides that the amounts with respect to which reporting is required by subsection (a) are (except as otherwise provided by sec. 6044): (A) Patronage dividends paid in cash, qualified written notices of allocation, or other property (except nonqualified written notices of allocation); (B) in the case of an exempt farmers' cooperative, amounts described in section 1382(c)(2)(A) (relating to amounts paid with respect to nonpatronage earnings) which are paid in money, qualified written notices of allocation, or other property (except nonqualified written notices of allocation); (C) amounts described in section 1382(b)(2) paid in redemption of nonqualified written notices of allocation which were previously paid as patronage dividends; and (D) amounts described in section 1382(c)(2)(B) paid by an exempt farmers' cooperative in redemption of nonqualified written notices of allocation previously paid with respect to nonpatronage earnings. The cooperative is required to report these amounts even though it must pay tax with respect to them because they were not paid within the prescribed time limits.

Subsection (b)(2) provides that information reporting shall not be required, to the extent provided in regulations prescribed by the Secretary of the Treasury or his delegate, with respect to any payment (A) by a foreign corporation, or (B) to a foreign corporation, a nonresident alien, or a partnership not engaged in trade or business in the United States and composed in whole or in part of nonresident aliens.

(c) *Exemption for certain consumer cooperatives.*—Subsection (c) of the new section 6044 provides that a cooperative which the Secretary of the Treasury or his delegate determines is primarily engaged in selling at retail goods or services of a type that are generally for personal, living, or family use is to be granted exemption from the requirements of information reporting imposed by subsection (a) upon application for such exemption to the Secretary of the Treasury or his delegate. The application for exemption is to be made in accordance with regulations prescribed by the Secretary of the Treasury or his delegate.

(d) *Determination of amount paid.*—Subsection (d) provides that for purposes of section 6044, in determining the amount of any payment, property (other than a written notice of allocation) is to be taken into account at its fair market value, and a qualified written notice of allocation is to be taken into account at its stated dollar amount.

(e) *Statements to be furnished to persons with respect to whom information is furnished.*—Subsection (e) provides that every cooperative making a return under subsection (a)(1) shall furnish to each person whose name is set forth in such return a written statement showing (1) the name and address of the cooperative making the return, and (2) the aggregate amount of payments to the person as shown on the return. This written statement is to be furnished to the person on or before January 31 of the year following the calendar year for which the return under subsection (a)(1) was made. However, no statement is required to be furnished to any person under this subsection if the aggregate amount of payments to the person as shown on the return made under subsection (a)(1) is less than $10.

SECTION 19. REPORTING OF INTEREST, DIVIDEND, AND PATRONAGE DIVIDEND PAYMENTS OF $10 OR MORE DURING A YEAR (Continued)

(c) *Returns regarding payments of interest.*—Subsection (c) of the new section 19 amends subpart B of part III of subchapter A of chapter 61 of the code (relating to information concerning transactions with other persons) by adding a new section 6048 to such subpart B.

SECTION 6048. RETURNS REGARDING PAYMENTS OF INTEREST

(a) *Requirement of reporting.*—Paragraph (1) of new section 6048(a) requires every person making payments of interest (as defined in subsec. (b)) aggregating $10 or more to any other person during any calendar year to report such payments. In addition, paragraph (1) requires persons receiving payments of interest (as defined in subsec. (b)) in the capacity of nominee to report payments by them aggregating $10 or more during any calendar year to any other person with respect to such interest so received. The return to be filed under paragraph (1) is to be made according to the forms or regulations prescribed by the Secretary of the Treasury or his delegate and is to set forth the name and address of the person to whom the payments were made and the aggregate amount of such payments.

Paragraphs (2) and (3) restate, in general, provisions of existing law (sec. 6041(c)). Paragraph (2) provides that, when required by the Secretary of the Treasury or his delegate, every person who makes payments of interest (as defined in subsec. (b)) aggregating less than $10 to any other person during any calendar year is to make a return setting forth the aggregate amount of such payments and the name and address of the person to whom paid. Under existing law the Secretary of the Treasury or his delegate has discretionary authority to require every corporation making payments of interest, regardless of amounts, to report the amounts so paid. Paragraph (2) limits the discretionary authority of the Secretary of the Treasury or his delegate to require information returns, with respect to payments of interest defined in subsection (b), to such payments to another person aggregating less than $10 during a calendar year. Payments aggregating $10 or more during the year must be reported under subsection (a)(1).

Paragraph (3) provides that, when required by the Secretary of the Treasury or his delegate, every corporation making payments, regardless of amounts, of interest other than interest as defined in subsection

(b), is to make a return according to the forms or regulations prescribed by the Secretary of the Treasury or his delegate, setting forth the amount paid and the name and address of the recipient of each such payment.

(b) *Interest defined.*—Subsection (b)(1) of the new section 6048 defines the term "interest" for purposes of subsections (a) (1) and (2) of such section to mean:

(A) Interest on evidences of indebtedness (including bonds, debentures, notes, and certificates) issued by a corporation in registered form, and to the extent provided in regulations prescribed by the Secretary of the Treasury or his delegate, interest on other evidences of indebtedness issued by a corporation of a type offered by corporations to the public. For this purpose, an instrument is in registered form if its transfer must be effected by the surrender of the old instrument and either the reissuance of the old instrument by the corporation to the new holder or the issuance by the corporation of a new instrument to the new holder. If an instrument can be transferred by endorsement it is not in registered form even though a list is maintained by the corporation of such instruments issued by it.

As used in subsection (b)(1) the term "of a type offered by corporations to the public" refers to a type of instrument. In determining whether a particular instrument comes within the scope of the term it is immaterial whether the particular instrument (or any instrument of the issue of which it is a part) actually was offered to the public so long as it is of a type which is offered by corporations to the public. Therefore, in a case where an entire issue is offered by a corporation only to its shareholders, the instruments come within the scope of the term if they are of a type offered by corporations to the public. The term does not have reference to instruments of a type offered by corporations only to other corporations. Coupon bonds issued by a corporation are an example of an evidence of indebtedness with respect to which the Secretary of the Treasury or his delegate may require information reporting under subsections (a) (1) and (2).

(B) Interest on deposits with persons carrying on the banking business. This includes interest paid or credited by any individual or organization carrying on the banking business.

(C) Amounts (whether or not designated as interest) paid or credited by a mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, or similar organization, in respect of deposits, investment certificates, or withdrawable or repurchasable shares. This includes interest paid with respect to face amount certificates.

(D) Interest on amounts held by an insurance company under an agreement to pay interest thereon. This subparagraph includes interest paid with respect to policy dividends held by an insurance company, and interest on the proceeds of an insurance policy held by an insurer under an agreement to pay interest thereon. This paragraph does not apply to amounts which represent the so-called "interest element" in the case of annuity or installment payments under a life insurance or endowment contract.

(E) Interest on deposits with stockbrokers and dealers in securities. This subparagraph includes interest on deposits with

stockbrokers, bondbrokers, and other persons engaged in the business of dealing in securities.

Subsection (b)(2) provides that, for purposes of subsection (a) (1) and (2), the term "interest" does not include:

(A) Interest on obligations described in section 103(a) (1) or (3) of the code (relating to obligations of a State, etc.);

(B) To the extent provided in regulations prescribed by the Secretary of the Treasury or his delegate, any amount paid by or to a foreign corporation, a nonresident alien, or a partnership not engaged in trade or business in the United States and composed in whole or in part of nonresident aliens; and

(C) Any amount on which the person making payment is required to deduct and withhold a tax under section 1451 (relating to tax-free covenant bonds) or would be so required but for section 1451(d) (relating to benefit of personal exemptions). Thus, the payment of interest on a tax-free covenant bond issued before January 1, 1934, is not required to be reported under subsection (a) (1) and (2). The fact that the person entitled to receive such interest files with the payer a signed notice in writing, as provided in section 1451(d) of the 1954 Code, claiming benefit of the deduction for personal exemptions provided in section 151 of the code, thereby relieving the payer of the duty to withhold a tax under section 1451(a), does not abrogate the exception provided by this subparagraph.

(c) *Statements to be furnished to persons with respect to whom information is furnished.*—Subsection (c) of the new section 6042 requires every person making a return under subsection (a)(1) to furnish to each person whose name is set forth in such return a written statement showing (1) the name and address of the person making the return, and (2) the aggregate amount paid to the person as shown on the return. Such written statement is to be furnished to the person on or before January 31 of the year following the calendar year for which the return under subsection (a)(1) was made. However, no statement is required to be furnished to any person under this subsection if the aggregate amount of payments to the person as shown on the return made under subsection (a)(1) is less than $10.

SECTION 19. REPORTING OF INTEREST, DIVIDEND, AND PATRONAGE DIVIDEND PAYMENTS OF $10 OR MORE DURING A YEAR (Continued)

(d) *Penalties for failure to file information returns.*—Subsection (d) of section 19 of the bill amends section 6652 of the 1954 Code (relating to failure to file information returns) to provide a new civil penalty for failure to file an information return with respect to payments aggregating $10 or more, respectively, of dividends, interest, or patronage dividends as required by the amendments made to the code by subsections (a), (b), and (c) of the new section 19, and to reflect the other amendments with respect to information reporting made by such subsections.

SECTION 6652. FAILURE TO FILE CERTAIN INFORMATION RETURNS

(a) *Returns relating to payments of dividends, interest, and patronage dividends.*—Subsection (a) provides a new penalty of $10 per statement for each failure to file a statement of the aggregate amount of payments to another person, as required by section 6042(a)(1) (relating to payments of dividends aggregating $10 or more), section 6044(a)(1) (relating to payments of patronage dividends aggregating $10 or more), or section 6048(a)(1) (relating to payments of interest aggregating $10 or more), on the date prescribed therefor (determined with regard to any extension of time for filing). No penalty is to be imposed, however, with respect to a failure to file a statement, if it is shown by the payer that the failure was due to reasonable cause and not to willful neglect. The penalty is to be paid, upon notice and demand by the Secretary of the Treasury or his delegate and in the same manner as tax, by the person failing to so file the statement. The total amount imposed on the delinquent person for all such failures during any calendar year shall not exceed $25,000.

(b) *Other returns.*—Subsection (b) retains the penalty provided under existing section 6652 for failures to file information returns not covered by the new $10 penalty in subsection (a). Subsection (b) provides a penalty of $1 for each failure to file a statement, at the proper time, of a payment to another person required under authority of section 6041 (relating to certain information at source), section 6042(a)(2) (relating to payments of dividends aggregating less than $10), section 6044(a)(2) (relating to payments of patronage dividends aggregating less than $10), section 6048(a)(2) (relating to payments of interest aggregating less than $10), section 6048(a)(3) (relating to other payments of interest by corporations), or section 6051(d) (relating to information returns with respect to income tax withheld). The penalty is to be imposed, with respect to each failure, unless it is shown that the failure was due to reasonable cause and not to willful neglect. The penalty is to be paid, upon notice and demand by the Secretary of the Treasury or his delegate and in the same manner as tax, by the person failing to so file the statement. The total amount imposed on the delinquent person for all such failures during the calendar year shall not exceed $1,000.

SECTION 19. REPORTING OF INTEREST, DIVIDEND, AND PATRONAGE DIVIDEND PAYMENTS OF $10 OR MORE DURING A YEAR (Continued)

(e) *Penalty for failure to furnish statements to persons with respect to whom returns are filed.*—Subsection (e) of the new section 19 amends subchapter B of chapter 68 (relating to assessable penalties) by adding to such subchapter a new section 6678 to provide civil penalties for failure to furnish statements to persons to whom dividends, patronage dividends, or interest are paid as required by the amendments made to the code by subsections (a), (b), and (c) of the new section 19.

SECTION 6678. FAILURE TO FURNISH CERTAIN STATEMENTS

Section 6678 provides a penalty of $10 for each failure to furnish a statement under section 6042(c), 6044(e), or 6048(c) on the date

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prescribed therefor to a person with respect to whom an information return has been made under section 6042(a)(1), 6044(a)(1), or 6048(a)(1), respectively. The penalty is to be imposed unless it is shown that such failure was due to reasonable cause and not to willful neglect. The penalty is to be paid, upon notice and demand by the Secretary of the Treasury or his delegate and in the same manner as tax, by the person failing to so furnish the statement. The total amount imposed on the delinquent person for all such failures during any calendar year shall not exceed $25,000.

(f) *Technical amendments.*—Subsection (f) of the new section 19 amends section 6041 of the code, relating to information at source, to reflect the amendments made to the code by subsections (a), (b), and (c) of the new section 19.

Paragraph (1) amends section 6041(a) of the code (relating to information returns with respect to payments of $600 or more) in order to exclude from the application of such section payments of dividends, patronage dividends, and interest aggregating, respectively, $10 or more during any calendar year to another person, and to exclude from such application other payments of dividends, patronage dividends, and interest with respect to which the Secretary of the Treasury or his delegate requires information returns under the authority of sections 6042(a)(2), 6044(a)(2), 6045, 6048(a)(2), and 6048(a)(3) as amended, or added to the code, by your committee's amendment.

Paragraph (2) further amends section 6041 of the code by striking out subsection (c) thereof (relating to payments of interest by corporations) since the provisions of such subsection are contained in the new section 6048 added to the code by subsection (c) of section 19 of the bill.

(g) *Clerical amendments.*—Subsection (g) of section 19 of the bill bill makes certain clerical amendments to the code to reflect the other amendments made to such code by section 19 of the bill.

(h) *Effective date.*—Subsection (h) of section 19 of the bill provides effective dates for the application of the provisions of such section 19 with respect to payments of dividends, interest, and patronage dividends.

Paragraph (1) provides that, except as provided in paragraph (2), the provisions of section 19 of the bill are to apply with respect to payments of dividends and interest on or after January 1, 1963.

Paragraph (2) provides that the provisions of section 19 of the bill are to apply with respect to payments of amounts described in section 6044(b) of the code (relating to returns regarding patronage dividends) on or after January 1, 1963, with respect to patronage occurring on or after the first day of the first taxable year of the cooperative beginning on or after January 1, 1963.

SECTION 20. INFORMATION WITH RESPECT TO CERTAIN FOREIGN ENTITIES

This section is the same as section 20 of the bill as passed by the House except for certain changes in the constructive ownership rules and in the penalty provision under section 6038 of the code, as amended by the bill (relating to information to be furnished with respect to certain foreign corporations), and except for certain changes in section

6046 of the code, as amended by the bill (relating to information as to the organization or reorganization of foreign corporations and as to acquisitions of their stock). The changes in section 6046 are, in general, as follows: (1) Officers or directors need not file returns unless there are one or more U.S. persons owning 5 percent or more in value of the stock of their foreign corporation; (2) the information required of officers and directors is limited to the names and addresses of U.S. persons who are 5 percent or more shareholders; and (3) information need not be furnished unless such information was required under regulations in effect 90 days prior to the date on which a person becomes liable to file a return.

(a) *Information to be furnished by individuals, domestic corporations, etc., with respect to certain foreign corporations.*—Subsection (a) of section 20 of the bill amends section 6038 of the 1954 Code. Section 6038(a)(1) requires every U.S. person to furnish the information required by such section with respect to any foreign corporation which such person controls (as defined in sec. 6038(d), as amended by the bill). Under existing law, the obligation to furnish information is imposed only on domestic corporations and only with respect to controlled foreign corporations and foreign subsidiaries of such controlled foreign corporations.

The requirements as to the information to be furnished are not changed except that (1) because of the redefinition of "control" including the addition of most of the constructive ownership rules of section 318(a) of the 1954 Code, there will be an increase in the number of persons whose transactions with controlled corporations must be reported, and (2) the Secretary of the Treasury or his delegate is authorized to require the furnishing of any other information which is similar or related in nature to that specified in paragraph (1) of section 6038(a) as amended by the bill.

Under the amendment made by section 20(a) of the bill, the period for which information is to be furnished under section 6038(a)(2) is modified to provide that, in all cases, such period is that ending with or within the U.S. person's taxable year. The amendment does not change the period with respect to a first-tier foreign corporation. However, with respect to a foreign subsidiary of such corporation, the period is changed from that ending with or within the first-tier corporation's annual accounting period to that ending with or within the U.S. person's taxable year. Thus, the effect of the amendment will be to obtain information which is more current from the subsubsidiary.

Section 6038(a)(3), as amended by the bill, is the same as existing law. It provides that no information will be required to be furnished under section 6038(a) with respect to any foreign corporation for any annual accounting period unless such information was required to be furnished under regulations in effect on the first day of such annual accounting period.

Section 6038(b), which sets forth the penalty for failure to file the required information within the prescribed time, is amended to provide that the reduction in foreign taxes paid or deemed paid now provided by section 6038(b) will occur in applying section 901 as well as section 902, although it will not occur under both sections with respect to the same tax. In addition, the reduction is to apply in respect of taxes deemed paid under section 960 of the code (added by sec. 12(a) of

the bill). Also, the penalty provided by section 6038(b), as amended by the bill, is extended to other than corporate taxpayers. Your committee has added a limitation on the penalty provided by section 6038(b) to the effect that the amount of the reduction in foreign tax credit under section 6038(b)(1) for each failure to furnish information with respect to a foreign corporation required under section 6038(a)(1) will not exceed the greater of (1) $10,000, or (2) the income of the foreign corporation for its annual accounting period with respect to which the failure occurs.

The reduction in foreign taxes paid or deemed paid for failure to file the required information within the prescribed time is not to apply, however, in computing accumulated profits in excess of income, war profits, and excess profits taxes under section 902 (a) and (b) of the code (relating to foreign tax credit for a corporate stockholder of a foreign corporation) or under section 960(a) of the code (added by sec. 12(a) of the bill).

Section 6038(c), as amended by the bill, provides that where two or more persons are required to furnish information with respect to the same controlled foreign corporation for the same period, the Secretary of the Treasury or his delegate may prescribe that such information will be required only from one person. To the extent practicable, the Secretary's determination is to be based on actual ownership of stock (as distinguished from constructive ownership).

Section 6038(d) defines "control" as the possession of more than 50 percent of the combined voting power, or of the value, of all classes of stock. A person in control of a corporation which, in turn, owns more than 50 percent of the combined voting power, or of the value, of all classes of stock of another corporation is also treated as in control of such other corporation. Thus, for example, in the case of a chain of corporations consisting of corporation M, owning 51 percent of the voting stock in corporation N, owning, in turn, 51 percent of the voting stock in corporation O, owning, in turn, 51 percent of the voting stock in corporation P; corporation P is controlled by corporation M. The bill as passed by the House provided that the rules of section 318(a) apply in determining stock ownership, except that the rule which requires ownership of 50 percent of the stock of a corporation before stock owned by such corporation is attributed to its stockholders applies without regard to the 50-percent limitation. The constructive ownership rules apply in determining control of domestic and foreign corporations but not in determining, under section 6038(a)(1)(D)(iii), whether a transaction is with a corporation 10 percent or more of the value of any class of stock of which is owned by a U.S. person.

With respect to their application under section 6038, the bill, as amended by your committee, makes the following changes in the rules of section 318(a) as modified by the bill as passed by the House:

(1) The rules that stock owned by or for a partner or a beneficiary of an estate or trust shall be considered as owned by the partnership, estate, or trust will not be applied so as to consider a U.S. person as owning stock owned by a person who is not a U.S. person, nor will a corporation be considered as owning stock owned by or for a 50 percent or more shareholder where the effect is to consider a U.S. person as owning stock which is owned by a person who is not a U.S. person.

(2) The rule that requires ownership of 50 percent (the bill as passed by the House removed this limitation) of the stock of a corporation before stock owned by such corporation is attributed to its stockholders has been modified by substituting the phrase "10 percent" for the phrase "50 percent."

(3) The rule that attributes to a corporation stock owned by or for persons owning the stock of such corporation will not apply.

The amended section 6038(d) defines the "annual accounting period" of a foreign corporation as the annual period on the basis of which such corporation regularly computes its income in keeping its books.

Section 6038(e) provides cross-references to sections 7203 and 7701(a)(30), respectively, for provisions relating to penalties for violations of section 6038, and for the definition of the term "U.S. person."

(b) *Information as to organization or reorganization of foreign corporations and as to acquisitions of their stock.*—Subsection (b) of section 20 of the bill amends section 6046 of the 1954 Code.

Paragraph (1) of section 6046(a), as amended by the bill as passed by the House, required an information return from each U.S. citizen or resident who, on January 1, 1963, was an officer or director of a foreign corporation or who became such an officer or director at any time after that date. In lieu of this provision, the bill, as amended by your committee, requires an information return from each U.S. citizen or resident who is on January 1, 1963, an officer or director of a foreign corporation, 5 percent or more in value of the stock of which is owned by a U.S. person, or who becomes such an officer or director at any time after such date.

Paragraph (2) of section 6046(a) requires each U.S. person to file an information return under any of the following circumstances:

(1) He owns 5 percent or more in value of the stock of a foreign corporation on January 1, 1963.

(2) He owns stock of a foreign corporation on January 1, 1963, which has a value of less than 5 percent of the value of the stock of such corporation, or owns no stock on January 1, 1963, and thereafter acquires stock which, when added to the stock held on January 1, 1963, if any, has a value equal to 5 percent or more of the value of the stock of such foreign corporation.

(3) He acquires an additional 5 percent or more in value of the stock of a foreign corporation.

Paragraph (3) of section 6046(a) requires each person who becomes a U.S. person after January 1, 1963, while owning 5 percent or more in value of the stock of a foreign corporation to file an information return.

Example.—A, a U.S. person, who on January 1, 1963, owns 2 percent in value of the stock of foreign corporation M, is not required to file an information return under section 6046. However, when he acquires, on April 1, 1963, an additional block of stock consisting of 4 percent in value of the stock of such corporation, he is required by subparagraph (A) of section 6046(a)(2) to make an information return with respect to corporation M. If, on December 31, 1964, he acquires a 6-percent block of stock in addition to that already owned, he is required to file a return under subparagraph (B) of section 6046(a)(2). He is not required to report when, on May 1, 1965, he acquires an

additional 3-percent block of stock, but he is required to report under subparagraph (B) when, on November 30, 1965, he acquires a 4-percent block of stock because the last two blocks of stock total more than 5 percent.

Subsection (b) of section 6046, as amended by the bill as passed by the House, was the same as existing law. It provided that the information returns required by subsection (a) of section 6046 shall be in such form and shall set forth, in respect of the foreign corporation, such information as the Secretary of the Treasury or his delegate prescribes by forms or regulations as necessary for carrying out the provisions of the income tax laws. Your committee has added a provision which limits the information which may be required of persons described in subsection (a)(1) to the names and addresses of persons described in subsection (a)(2).

Subsection (c) of section 6046 is amended by omitting the definition of "U.S. shareholder". The term "U.S. person", as used in sections 6038 and 6046, as amended by the bill, has the same substantive meaning as the term "U.S. shareholder" in existing section 6046.

Subsection (d) of section 6046, as amended by the bill, provides a limitation on the time for filing a return required by subsection (a) of such section. Such return must be filed on or before the 90th day after the day on which, under any provision of section 6046(a), the U.S. citizen, resident, or person becomes liable to file such return.

Your committee has redesignated subsection (e) of section 6046 (as amended by the bill as passed by the House) as subsection (f) and added a new subsection (e) which provides that no information shall be required to be furnished under section 6046 with respect to any foreign corporation, if the liability of the U.S. citizen, resident, or person to file a return under subsection (a) arises on or after January 1, 1963, and before March 1, 1963, unless such information was required to be furnished under regulations which have been in effect since January 1, 1963 (but only if such regulations were prescribed before December 1, 1962); or, if the liability of the U.S. citizen, resident, or person to file a return under subsection (a) arises on or after March 1, 1963, unless such information was required to be furnished under regulations which have been in effect for at least 90 days.

Subsection (f) of section 6046, as amended by the bill, is a cross-reference to section 7203, relating to willful failure to file a return, supply information, or pay tax.

(c) *Civil penalty for failure to file return.*—Subsection (c) of section 20 of the bill amends subchapter B of chapter 68 (relating to assessable penalties) by adding new section 6679.

Subsection (a) of section 6679, similar in purpose to section 6677 (relating to failure to file information returns with respect to certain foreign trusts) as added by section 7(g) of the bill, provides that in addition to any criminal penalty provided by law, any person required to file a return under section 6046 who fails to file such return at the time provided in section 6046, or who files a return which does not show the information required pursuant to such section, must pay a penalty of $1,000, unless it is shown that such failure is due to reasonable cause.

Subsection (b) of section 6679 provides that subchapter B of chapter 63 (relating to deficiency procedure for income, estate, and gift taxes) is inapplicable in respect of the assessment or collection of any penalty imposed by subsection (a).

(d) *Technical amendments.*—Subsection (d) of section 20 of the bill contains technical amendments adding a cross-reference to section 318 of the code and conforming the appropriate table of sections to the change in the heading of section 6046.

(e) *Effective date.*—Under subsection (e) of section 20 of the bill, section 6038 of the code as amended by the bill is to apply with respect to annual accounting periods of foreign corporations beginning after December 31, 1962, and section 6046 of the code as amended by the bill is to take effect on January 1, 1963. Under subsection (e)(1), existing section 6038 will continue to apply in respect of a foreign corporation or foreign subsidiary whose annual accounting period begins before January 1, 1963. For example, assume that D, a domestic corporation, has a taxable year beginning July 1, 1963, and ending June 30, 1964. F, a foreign corporation controlled by D, has an annual accounting period beginning January 1, 1963, and ending December 31, 1963. FS, a foreign subsidiary of F, has an annual accounting period beginning April 1, 1962, and ending March 31, 1963. Under the effective date provision, information with respect to FS's annual accounting period beginning April 1, 1962, and ending March 31, 1963, is to be furnished under existing law, and information with respect to F's annual accounting period beginning January 1, 1963, and ending December 31, 1963, is to be furnished under section 6038 as amended by the bill.

SECTION 21. EXPENDITURES BY FARMERS FOR CLEARING LAND

Section 21 of the bill, which is a new section added to the bill as passed by the House, amends the Internal Revenue Code of 1954 by adding a new section 182, relating to the tax treatment of expenditures by farmers for clearing land.

Subsection (a) of section 182 permits farmers to elect to treat as deductible expenses, rather than as nondeductible improvements to property, expenditures for clearing land if such expenditures are for the purpose of making the land suitable for use in farming.

Subsection (b) of section 182 limits the deduction under subsection (a) for any taxable year to $5,000, or to 25 percent of the taxable income derived from farming during the taxable year, whichever amount is the lesser. For purposes of such 25-percent limitation, the term "taxable income derived from farming" means the gross income of the taxpayer derived from farming during the taxable year, that is, the gross income of the taxpayer from the production of crops, fruits, or other agricultural products or from livestock, reduced by the allowable deductions which are attributable to the business of farming other than the deduction allowed by section 182. Thus, all of the ordinary and necessary expenses paid or incurred in the business of farming, including amounts allowed as deductions by sections 175 and 180 for soil and water conservation expenditures and for lime and fertilizer expenditures, respectively, but not including the amount allowed as a deduction by section 182 for expenditures for clearing land, should be deducted from gross income derived from farming in computing the taxable income derived from farming for purposes of applying the 25-percent limitation on the amount deductible as an expenditure for clearing farm land.

The term "clearing of land" is defined in subsection (c)(1) of section 182 to include, but is not limited to, the eradication of trees, stumps, and brush, the treatment or moving of earth, and the diversion of streams and watercourses. Your committee's amendment has application only in respect of expenditures paid or incurred in the clearing of land for the purpose of making such land suitable for use in farming. The term "land suitable for use in farming" means land which as a result of the clearing of land, as described above, is suitable for use by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock.

Subsection (d)(1) of section 182 provides that the expenditures to which section 182(a) applies do not include expenditures for the purchase, construction, installation, or improvement of structures, appliances, or facilities which are of a character which is subject to the allowance for depreciation. In addition, such expenditures do not include any expense which is deductible under any other section of the code.

Subsection (d)(2) of section 182 provides that expenditures to which section 182(a) applies shall include a reasonable allowance for depreciation with respect to property which is used in the clearing of land for the purpose of making such land suitable for use in farming and which if used in a trade or business, would be property subject to the allowance for depreciation. Under present law such depreciation must be capitalized. Such subsection (d)(2) further provides that to the extent an amount representing a reasonable allowance for depreciation with respect to property used in clearing land is treated as an expenditure to which subsection (a) applies, such expenditure shall, for purposes of chapter 1 of the 1954 Code, be treated as amount allowed under section 167 for depreciation of such property. Under this provision, proper adjustment to the basis of such property would be made under section 1016(a) of the 1954 Code.

Subsection (e) of section 182 provides that the taxpayer shall make the election to deduct his expenditures for clearing his land within the time prescribed by law (including extensions thereof) for filing his return for any taxable year in which he pays or incurs such expenditures, and that such election shall be made in such manner as the Secretary of the Treasury or his delegate may by regulations prescribe. Once the election is made for any taxable year such election may not be revoked without the consent of the Secretary of the Treasury or his delegate.

SECTION 22. CHARITABLE CONTRIBUTIONS MADE FROM INCOME ATTRIBUTABLE TO SEVERAL TAXABLE YEARS

Section 22 of the bill, which is a new section added to the bill as passed by the House, amends section 1307 of the Internal Revenue Code of 1954 by adding a new subsection (e) thereto. Section 1307 relates to rules applicable to part I of subchapter Q of such code which part relates to income attributable to several taxable years.

Part I of subchapter Q provides a limitation with respect to the tax imposed on certain amounts received or accrued by an individual taxpayer during a taxable year. The tax attributable to any such amount for the taxable year in which it is received or accrued is, in general, not to be greater than the aggregate increases in taxes which would have resulted if the amount had been included in the taxpayer's

income, on an allocated basis, over the period specified in the applicable section of such part I.

It is the present position of the Internal Revenue Service that in computing tax in accordance with part I of subchapter Q the adjusted gross income for the taxable year in which the amount was received or accrued shall be computed without regard to that portion of such amount which is allocated to other taxable years. (See, Internal Revenue Mimeograph 43, 1952–2 C.B. 112.) The amounts allowable as deductions under section 170, relating to charitable, etc., contributions and gifts, and under section 213, relating to medical, dental, etc., expenses, are based upon percentages of adjusted gross income. The computation of adjusted gross income without including that portion of the amount received or accrued which is allocated to other taxable years results in a determination of adjusted gross income which is less than would be the case if adjusted gross income for the taxable year in which the amount was received or accrued were computed without regard to part I of subchapter Q. A lower adjusted gross income figure for the taxable year decreases the allowable deduction for charitable contributions and increases the allowable medical deduction.

New subsection (e) provides that an individual who receives or accrues in a taxable year an amount to which part I of subchapter Q applies may elect (in such manner and at such time as the Secretary of the Treasury or his delegate prescribes by regulations) to apply the provisions of subsection (e) in computing his tax liability under such part. If the taxpayer so elects, the amount received or accrued shall be reduced, for the purposes of computing his tax liability under such part I with respect to such amount, by an amount (1) which bears the same ratio to the amount of his allowable charitable deduction for the taxable year in which the amount was received or accrued (computed without regard to pt. I of subch. Q) as (2) the amount received or accrued during the taxable year to which part I applies bears to the adjusted gross income for such year (computed without regard to pt. I of subch. Q).

The last sentence of new subsection (e) provides that no portion of the amount received or accrued to which part I of subchapter Q applies shall (for purposes of computing the limitation on tax under such part) be taken into account for purposes of computing the limitation under section 170(b)(1) of the code for the taxable year in which the amount to which such part applies is received or accrued.

Example.—Assume the following facts with respect to individual I (who elects to have the new subsection (e) apply) for the taxable year 1963:

(1) Amount received or accrued to which pt. I of subch. Q applies	$12,000
(2) Adjusted gross income (determined without regard to pt. I of subch. Q)	16,000
(3) Deductible charitable contributions (determined without regard to pt. I of subch. Q)	1,600

Assume further that, for purposes of computing the limitation on tax under part I of subchapter Q, the $12,000 amount is to be prorated in equal amounts to the taxable years 1960, 1961, 1962, and 1963.

Under the first sentence of the new subsection (e), for purposes of computing the tax liability of the taxpayer under part I, the $12,000 is reduced by $1,200 (that portion of the $1,600 deductible charitable contributions which $12,000 is of $16,000). The remainder, $10,800,

is then prorated at the rate of $2,700 per year to 1960, 1961, 1962, and 1963.

Under the last sentence of the new subsection (e), for purposes of computing the limitation on tax under part I, the $12,000 amount is not to be taken into account for 1963 for purposes of computing the limitation under section 170(b)(1) on the amount deductible for charitable contributions during 1963. Thus, for this purpose, the adjusted gross income is to be treated as being $4,000 (the amount remaining after excluding $12,000 from $16,000).

SECTION 23. EFFECTIVE DATE OF SECTION 1371(c) OF THE INTERNAL REVENUE CODE OF 1954

Section 23 of the bill, which is a new section added to the bill as passed by the House, relates to the effective date of section 1371(c) of the Internal Revenue Code of 1954.

(a) *In general.*—Subsection (a) of section 23 of the bill provides that section 1371(c) of the code, which was added by section 2(a) of the Act of September 23, 1959 (Public Law 86–376), shall (notwithstanding the provisions of the first sentence of sec. 2(d) of such Act) also apply to taxable years beginning after December 31, 1957, and before January 1, 1960. Section 1371(c) provides that stock which is community property of a husband and wife (or the income from which is community income) under the applicable community property law of a State, or is held by a husband and wife as joint tenants, tenants by the entirety, or tenants in common, shall be treated as owned by one shareholder. The first sentence of section 2(d) of Public Law 86–376 provides that section 1371(c) is to apply to taxable years beginning after December 31, 1959. Under your committee amendment, if the provisions of subsections (b) and (c) of section 23 of the bill are met, section 1371(c) will now be applicable for all taxable years for which a corporation may elect to be taxed as an electing small business corporation under subchapter S (secs. 1371–1377) of the code.

The enactment of this new effective date for section 1371(c) does not relax or otherwise change the requirements of any of the provisions of subchapter S. Thus, in order to be eligible to be treated as an electing small business corporation for years beginning after December 31, 1957, and before January 1, 1960, a "small business corporation" must have filed a timely election for such year in accordance with section 1372 and in the manner prescribed by the Secretary of the Treasury or his delegate by regulations. Such election must have been valid in all respects except that by reason of counting a husband and wife owning stock of a corporation in the specified joint forms or as community property as two shareholders, the corporation failed to meet the requirement that a small business corporation must have 10 or fewer shareholders. Furthermore, shareholder consents to such elections must have been filed in the prescribed time and manner. However, the Commissioner has announced that he will consider, upon request, the granting of extensions of time for the filing of consents in certain cases under section 1.9100–1 of the Income Tax Regulations.

If all the requirements, except the 10-or-fewer-shareholder requirement, had been met for taxable years beginning after December 31, 1957, and before January 1, 1960, and the effect of applying the new effective date of section 1371(c) is to reduce the number of shareholders

to 10 or fewer, the election shall be treated as a valid election, and the corporation shall be treated as an electing small business corporation for the year of the election and all succeeding years (unless, even though sec. 1371(c) is applicable, the election has been terminated for any reason) if the corporation and the shareholders meet the requirements of subsections (b) and (c) of section 23 of the bill. The earlier effective date provided in subsection (a) is also available in those situations where the initial election was valid, but where a termination in a subsequent taxable year beginning before January 1, 1960, is attributable solely to the fact that, by counting a husband and wife owning stock in joint form or as community property as two shareholders, the corporation had more than 10 shareholders and thus failed to meet the definition of a small business corporation. In such a case, if the corporation and shareholders elect and consent as provided in subsections (b) and (c) of section 23 of the bill, such termination shall be disregarded, and such corporation shall be treated as an electing small business corporation for the year of the termination and all succeeding years (unless, even though sec. 1371(c) is applicable, the election has been terminated for any reason).

(b) *Election and consent by corporations; consent by shareholders.*—Subsection (b) of section 23 of the bill prescribes rules which must be complied with if the earlier effective date provided in subsection (a) is to apply with respect to any electing small business corporation and its shareholders.

Subsection (b)(1) provides that the earlier effective date for section 1371(c) shall not apply unless the corporation elects, within 1 year after the date of the enactment of the bill, to have the earlier effective date apply and consents to the application of subsection (c) (relating to tolling of statutes of limitations). Both the election to have the provisions of subsection (a) apply and the consent to the application of subsection (c) are to be made in such manner as the Secretary of the Treasury or his delegate prescribes by regulations.

Under subsection (b)(2), each shareholder of the corporation must consent to the corporation's election, and must also consent to the application of subsection (c), within 1 year after the date of the enactment of the bill. These consents, which must be filed in such manner and at such time as the Secretary of the Treasury or his delegate prescribes by regulations, are required of each person who is a shareholder of the corporation on the date the corporation makes the election under subsection (b)(1), and of each person who was a shareholder of the corporation at any time during any taxable year of the corporation beginning after December 31, 1957, and ending before the date of such election. It is contemplated that the election and consent by the corporation under subsection (b)(1) and the consents by its shareholders under subsection (b)(2) will be filed together.

(c) *Tolling of statutes of limitations.*—Subsection (c) of section 23 of the bill provides for a tolling of the statutes of limitations with respect to (1) the assessment of deficiencies, and (2) the credit or refund of overpayments, which are attributable to the application of the earlier effective date provided in subsection (a).

Subsection (c)(1) provides that if the assessment of any deficiency against the corporation making such election, or against any shareholder of such corporation who consents to such election, for any taxable year is prevented, at any time on or before the expiration of 1

year after the date of such election, by the operation of any law or rule of law, assessment of such deficiency may, nevertheless, be made, to the extent such deficiency is attributable to the application of subsection (a), at any time on or before the expiration of such 1-year period.

Subsection (c)(2) provides that if credit or refund of any overpayment of tax by the corporation making such election, or by any shareholder of such corporation who consents to such election, for any taxable year is prevented, at any time on or before the expiration of 1 year after the date of such election, by the operation of any law or rule of law, credit or refund of such overpayment may, nevertheless, be allowed or made, to the extent such overpayment is attributable to the application of subsection (a), if claim therefor is filed on or before the expiration of such 1-year period.

SECTION 24. CERTAIN LOSSE SUSTAINED IN CONVERTING FROM STREET RAILWAY TO BUS OPERATIONS

Section 24 of the bill, which is a new section added to the bill as passed by the House, relates to certain losses sustained in converting from street railway to bus operations.

(a) *In general.*—Subsection (a) of section 24 of the bill provides that if a corporation has a net operating loss for the taxable year ending December 31, 1953, or the taxable year ending December 31, 1954, principally as the result of conversion from street railway to bus operations with respect to part or all of the company's operations, then its unused conversion loss (as defined in subsec. (b)) will be subject to the treatment provided in subsection (c).

(b) *Unused conversion loss defined.*—Subsection (b) of section 24 of the bill defines an "unused conversion loss" as the aggregate of the net operating losses for the taxable years ending December 31, 1953 and 1954, reduced to the extent that they have been used as net operating loss carryovers or carrybacks to reduce taxable income for any taxable year beginning before January 1, 1960.

(c) *Treatment of unused conversion loss.*—Subsection (c) of section 24 of the bill provides that if a taxpayer has an unused conversion loss, it shall be treated by such taxpayer as a net operating loss for the taxable year ending December 31, 1959, in determining the amount of the net operating loss carryover from such taxable year to each of the 5 taxable years following such taxable year. Subsection (c) applies, however, only for years in which the taxpayer is engaged in the furnishing or sale of transportation (as defined in sec. 1503(c)(1)(A) of the 1954 Code).

(d) *Regulations.*—Subsection (d) of section 24 of the bill authorizes the Secretary of the Treasury or his delegate to prescribe by regulation such rules as may be necessary to carry out the purposes of this section.

SECTION 25. PENSION PLAN OF LOCAL UNION NO. 435, INTERNATIONAL HOD CARRIERS' BUILDING AND COMMON LABORERS' UNION OF AMERICA

Section 25 of the bill, which is a new section added to the bill as passed by the House, provides that the pension plan of Local Union No. 435 of the International Hod Carriers' Building and Common Laborers' Union of America, which was negotiated to take effect May 1, 1960, pursuant to an agreement between such union and the Building Trades Employers Association of Rochester, N.Y., shall be held and considered to have been a qualified trust under section 401(a) of the Internal Revenue Code of 1954, and to have been exempt from taxation under section 501(a) of such code, for the period beginning May 1, 1960, and ending April 20, 1961, but only if it is shown to the satisfaction of the Secretary of the Treasury or his delegate that the trust has not in this period been operated in a manner which would jeopardize the interests of its beneficiaries.

SECTION 26. CONTINUATION OF A PARTNERSHIP YEAR FOR SURVIVING PARTNER IN A TWO-MAN PARTNERSHIP WHERE ONE DIES

(a) *Close of taxable year of two-man partnership when one partner dies.*—Paragraph (1) of subsection (a) of section 26 of the bill is a clerical amendment the effect of which is to designate the text of section 188 of the Internal Revenue Code of 1939 as subsection (a) of section 188.

Paragraph (2) of subsection (a) of section 26 of the bill amends section 188 of the Internal Revenue Code of 1939 (relating to different taxable years of partner and partnership) by adding a new subsection (b). The new subsection (b) provides that for purposes of chapter 1 of the 1939 Code, if the surviving partner so elects within 1 year after the date of enactment of this bill, the death of one of the partners of a partnership consisting of two members shall not result in the termination of the partnership or in the closing of the taxable year of the partnership with respect to the surviving partner prior to the time the partnership year would have closed if neither partner had died or disposed of his interest.

(b) *Effective date, etc.*—Subsection (b) of section 26 of the bill provides that the amendments made by section 26 of the bill are to apply with respect to taxable years of a partnership beginning after December 31, 1946, to which the Internal Revenue Code of 1939 applies. Subsection (b) further provides that if refund or credit of any overpayment resulting from the application of the amendment made by new section 188(b) (including interest, additions to the tax, and additional amounts), is prevented on the date of enactment of this bill, or within 1 year from such date, by the operation of any law or rule of law (other than sec. 3760 of the Internal Revenue Code of 1939 or sec. 7121 of the Internal Revenue Code of 1954, relating to closing agreements, and other than sec. 3761 of the Internal Revenue Code of 1939 or sec. 7122 of the Internal Revenue Code of 1954, relating to

compromises), such refund or credit or such overpayment, may, nevertheless, be made or allowed if claim therefor is filed within 1 year after the date of enactment of this bill. Furthermore, no interest shall be allowed or paid on any overpayment resulting from the enactment of this section.

SECTION 27. TREATIES

Section 7852(d) of the 1954 Code provides that no provision of the 1954 Code shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on August 16, 1954. The bill as passed by the House provided that section 7852(d) would not apply in respect of any amendment made by the bill, thus providing that in the event there was any conflict with any treaty provision (whether or not such provision was in effect on August 16, 1954) the provisions of the bill would govern. Your committee has stricken this provision and substituted for it an amendment providing that no provision of the bill shall apply in any case where its application would be contrary to any treaty obligation of the United States.

CHANGES IN EXISTING LAW

In the opinion of the committee, it is necessary, in order to expedite the business of the Senate, to dispense with the requirements of subsection 4 of rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, as reported).

INDIVIDUAL VIEWS OF SENATORS HARRY F. BYRD, ALBERT GORE, JOHN J. WILLIAMS, AND CARL T. CURTIS ON SECTION 2 OF H.R. 10650

We oppose section 2 of the 1962 revenue bill (H.R. 10650) which would give a 7-percent tax credit to segments of business for investment in new machinery and equipment.

Our opposition to this section of the bill is based on firm convictions after full consideration of views expressed by competent witnesses in exhaustive hearings, and those expressed in voluminous correspondence from the general public.

We have given closest possible study to statements in behalf of the administration's recommendations made before the Senate Finance Committee which, in some respects, are at variance with provisions now in the section.

Before adopting the "investment credit" (sec. 2) provisions as reported, the Senate must consider the fact that the Internal Revenue Service on July 11, 1962, substantially revised its regulations to accelerate regular depreciation.

Our position is in accord with views of a vast number of citizens, including those representing industry, business, labor, and agriculture throughout the Nation, who have testified and counseled for rejection of the provisions of section 2.

Hearings on the pending bill were held over a period of 4 months, and a substantial portion of the testimony taken was directed to section 2. Generally, our conclusions may be summarized, but the detail must be considered, too.

In summary, we oppose "investment credit" as it would be provided by section 2 for numerous reasons including the facts that—

(1) It would be a subsidy in the nature of a windfall to be given to businesses which comply with a Government policy.

(2) It would be discriminatory in its application among various businesses, even among those similar in kind.

(3) Its value and its need as a stimulant to so-called "economic growth" are both questionable and doubtful.

(4) Its continuing cost would be heavy and it would increase the Federal deficit in the current fiscal year.

WOULD INCREASE DEFICIT

There was a Federal deficit of $6.3 billion in fiscal year 1962 which ended June 30. There will be another deficit in the current fiscal year which started July 1. The "investment credit" provisions in H.R. 10650 would increase the 1963 deficit by $630 million (net).

The staff of the Joint Committee on Internal Revenue Taxation, using officially budgeted expenditures, estimates that—

(1) The Federal deficit in the current fiscal year 1963 will be more than $3.9 billion, excluding the effect of this bill.

(2) This Federal deficit would be increased by a total of more than $1 billion if H.R. 10650, as passed by the House of Representatives, were enacted; and

(3) The Federal deficit estimate would have to be increased by a total of $630 million (net) if the bill, as reported by the Senate Finance Committee, were enacted.

If H.R. 10650—in either the House or the Senate committee version—were enacted, a substantial portion of the estimated increase in the Federal deficit would be directly attributable to the effect of the "investment credit" provisions alone. The Joint Committee staff estimates that—

(1) Under the House-passed version of the "investment credit" provisions, revenue in fiscal year 1963 would be reduced by $1.3 billion; and

(2) Under the Senate committee version of the "investment credit" provisions, revenue in fiscal year 1963 would be reduced by $650 million (gross).

If the "investment credit" provisions of section 2 remain in this bill and the measure is enacted, they will become permanent in the law. For this reason it is appropriate for the Senate at this time to examine the long-range budgetary effects.

When this is done, the enormity of the revenue loss becomes even more clear, and the budgetary effect becomes even more significant. Extending application of the "investment credit" provisions over an 11-year period (1962–72), the Joint Committee staff finds that—

(1) Business tax liabilities would be reduced during that period by $21 billion under the House-passed version; and

(2) Business tax liabilities would be reduced during that period by $15.6 billion under the Senate committee version.

Revenue loss resulting from application of the new depreciation guidelines made effective by the Treasury Department on July 11, 1962, would be in addition to revenue loss resulting from the "investment credit" provisions in this bill if they were enacted.

The Treasury has estimated that in their first year of operation the recent revisions in Internal Revenue Service rules on depreciation will result in a reduction in business tax liabilities of $1.5 billion. Estimates for subsequent years have not been made.

WRONG IN PRINCIPLE

The "investment credit" proposed in section 2 of this bill is wrong in principle. It would be discriminatory in its application. It would do harm to our tax structure. It would not achieve so-called "growth" in investment. It is not needed under existing conditions.

Under terms of the bill, those complying with the "investment credit" provisions would be entitled to a tax credit which could be offset directly against income tax liability. Coupled with depreciation, "investment credit" would return to the investor more than he paid for the asset.

It should be made clear for the record and the information of the Senate that the tax "credit" would not be included in taxable income. If a corporate tax rate of about 50 percent were assumed, an "investment credit" of $7 would be equal to $14 of additional income before taxes in the year.

Under existing law and Internal Revenue Service regulations the cost of *plant*, machinery, and equipment generally may be depreciated 100 percent over specified periods; and depreciation has been accelerated under the new rules now in force.

Under the current administration proposal and House bill provisions "investment credit" for new machinery and equipment would be in addition to 100-percent depreciation. Under the Senate committee version of the bill the "investment credit" would be in addition to 93-percent depreciation.

The administration proposed an 8-percent "investment credit" (with public utilities excluded) on new machinery and equipment in addition to 100-percent depreciation. The effect of this would be to give investors generally 116 percent of what they paid for the asset.

The House bill generally would give a 7-percent "investment credit" for new machinery and equipment, with a 3-percent "credit" for public utilities, in addition to 100-percent depreciation. This would allow investors up to 114 percent of what they paid for the asset.

The Senate committee bill generally would give a 7-percent "investment credit" for new machinery and equipment, with 3 percent for public utilities, in addition to 93 and 97 percent depreciation respectively. This would allow investors up to 107 percent of what they paid for the asset.

Evidence given in hearings on this bill clearly shows that "investment credit" is both wrong in principle and unnecessary. Numerous witnesses, including those representing four major segments of the economy, opposed the principle involved.

In view of the testimony in the published record on this proposal, it is difficult to understand the persistence of the "investment credit" advocates. Leaders of industry, business, labor, and agriculture all have appeared before the Senate Finance Committee to oppose it.

Stanley H. Ruttenberg, research director, AFL–CIO, urged the committee to "delete this provision from the bill," because those he represented thought:

> It is a multibillion-dollar windfall that will not really contribute anything to our national goals and will not relieve our balance-of-payments problems as it is claimed.

Walter Slowinski, appearing in behalf of the U.S. Chamber of Commerce, with respect to the "investment credit" provisions, said:

> The chamber again recommends against the adoption of this novel and untried preferential tax credit subsidy for business. It is also unnecessarily complex, and it will be difficult to administer.

Harold H. Scaff, chairman, Tax Committee, National Association of Manufacturers, said "investment credit"—

> would simply provide reduction in effective tax rates for taxpayers who use their income and other funds as the Government thinks is best for the economy at a particular time.
>
> There has been a tendency to promote and discuss the investment tax credit apart from the price which it would exact in terms of other changes in the tax law. Even without the exaction of such a price, we would oppose the credit

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> for the reasons set forth in the appendix attached hereto. Very simply, we believe that tax reductions should be afforded by direct means. We would take this position even if, in our opinion, all of the other provisions of H.R. 10650 constituted sound tax policy.

Charles B. Shuman, president, American Farm Bureau Federation, took the position that—

> these provisions are both unsound and likely to have a number of undesirable effects. It would be far better to liberalize the treatment of depreciation and work toward a general reduction in income tax rates.
>
> The proposed investment credit is a selective form of tax relief—in reality a subsidy. * * * The result would be to give some taxpayers a competitive advantage at the expense of others.

Although the Farmers Union did not send a representative to testify directly before the Finance Committee, a communication signed by James G. Patton, president, National Farmers Union, published in the congressional record of March 29, 1962 (p. 4984), said:

> Urge your influence to delete provision giving huge private corporations operating at less than full capacity over $1½ billion and private electrical power monopoly over $100 million in tax subsidies which would result in the flight of capital overseas and further aggravate the dollar crisis.

The "investment credit" proposal would be discriminatory in obvious respects. It would discriminate against companies which were recently modernized, against poorer companies, and against companies needing new buildings with or without new machinery and equipment.

The very fact that "investment credit" would give special tax reduction only to those companies able and willing to invest in new machinery and equipment means that those who for any reason were unable to make such investments would be subjected to discrimination.

Struggling small companies unable to provide the funds for qualifying investments would not be eligible for the "credit," but their more prosperous competitors could reap a windfall from the Federal Government through special tax treatment.

None of the proposals—administration, House bill, or Senate committee bill—would give "investment credit" for new buildings or structural components. It is difficult to imagine installing expensive modern machinery and equipment in an old, outmoded building.

INEFFECTIVE AND QUESTIONABLE

Plans for new facilities contemplated by advocates of the "credit" are formulated far in advance. Many of those who would benefit from the proposal would have developed their improvements without the incentive of "investment credit."

In such cases the "credit" would be of questionable value as a stimulant to "economic growth." On the other hand, the proposal offers neither incentive nor immediate means of expansion for companies which are hard pressed for capital.

A recent McGraw-Hill survey developed the consensus that this "investment credit" proposal would increase 1962 investments by only about $300 million, or 1 percent. This raises the question of the effectiveness of section 2 as a stimulant for increased investment.

Witnesses before the Finance Committee also raised the question as to the effectiveness of "investment credit" in this respect. For example, Augustus W. Kelley, representing the Proprietary Association, said:

> The theory of the tax incentive in our opinion is based on the false premise that business investments are motivated substantially by tax considerations. In our industry, and we believe it is typical of others, the decision whether or not to invest in new machinery and equipment is based primarily on pure business consideration. Simply stated, we are not going to spend $1 just because the Government gives us 7 cents.

Otis H. Ellis, speaking for the National Jobbers Council, said:

> This tax credit will not be enough to induce a single jobber to buy one item more than what he would otherwise have purchased.

The McGraw-Hill survey, previously referred to, indicates that without the "investment credit" business investments in plant and equipment this year may be expected to reach some $38 billion. This would be $1 billion more than the previous record set in 1957.

If $38 billion is spent in new plant and equipment this year, it will exceed such investments of last year by $3.5 billion or 11 percent; and the same survey finds reason to expect continuing high level of investment for the period of 1963–65.

We believe the sound way to achieve a reduction in taxes is first to cut unnecessary Federal expenditures as a means of putting the Nation on a sound financial basis.

We do not believe that tax reductions should be discriminatory by favoring some taxpayers over others in the manner inherent in the "investment credit" proposal or otherwise.

We believe that revisions in the Federal revenue structure should not create new discriminatory and artificial distinctions among taxpayers such as this proposal would establish in the law.

We believe our attention should be directed toward reducing rather than increasing such inequities.

Harry F. Byrd.
Albert Gore.
John J. Williams.
Carl T. Curtis.

ADDITIONAL VIEWS OF SENATOR EUGENE J. McCARTHY ON H.R. 10650

In my opinion, neither section 2 of this bill, on the investment credit, or section 12, on controlled foreign corporations, provides an adequate solution to what are admittedly two important problems, and neither of these two sections is defensible in terms of equity or of administrative simplicity which should characterize our tax system.

INVESTMENT CREDIT

The tax credit for "qualified investment" is designed to stimulate what has been termed "a sluggish economy." I have no argument with the fact that our economy would profit from modernization of plant and equipment and from the expansion of certain productive facilities—even though we have substantial underutilization of productive capacity in many areas—but I question whether a selective and hence discriminatory tax credit is the cure for the Nation's investment maladies or economic problems. In my opinion, comprehensive business tax relief in the form of a general reduction in the corporation income tax, together with an across-the-board reduction in personal income tax rates, will better meet these needs by freeing money both for new investment and for consumption without binding business decisions to Government decisions and without creating the problem of distinguishing between qualified investment and nonqualified investment.

The investment credit as it stands in this bill today is but a pale representation of the original administration proposal. In his testimony before the Committee on Ways and Means in May 1961, Secretary Dillon said:

> * * * the purpose of the investment credit is not to provide general tax reduction for recipients of profit income. Rather it is to stimulate investment in the most efficient manner. The credit, therefore, should be focused on investment which would not have been undertaken without this inducement, and which will be most responsive to the stimulus which it provides.

Originally the administration recommended a 15-percent tax credit, most of which would have been available only for plant and equipment expenditures in excess of current depreciation allowances. A 6-percent credit was provided for certain investment below the level of these allowances, and a 10-percent credit on the first $5,000 of investment was provided whether it was more or less than depreciation allowances. The credit was not to be limited to tangible personal property, but also was to be available for most buildings and their structural components as well. The credit also was not to exceed

30 percent of a firm's tax liability. A 5-year carryforward of unused tax credits was provided.

The investment credit which passed the House in March of this year contained the following major changes: (1) A tax credit of 7 percent was granted on all new investment in eligible property, regardless of current depreciation allowances; (2) public utilities, excluded from any credit under the administration plan, were allowed a 3-percent credit; (3) the full credit was made available for assets with a useful life of 8 years or more and scaled down for assets with a useful life of 4 to 8 years; (4) the credit was limited to $25,000 plus 25 percent of a company's tax liability over this amount; (5) the property eligible for the credit excluded buildings and structural components as well as certain other property.

The Senate Finance Committee has made further changes, adding a 3-year carryback for unused tax credits, changing the effective date of the credit from January 1, 1962, to July 1, 1962, and stipulating that the depreciable base of property eligible for the credit shall be reduced by the amount of the credit.

The result of most of these changes has been to reduce the impact of the investment credit. Section 2 is now little more than a tax-relief measure, but the relief is restricted in its application to certain firms investing in certain types of property.

What is wrong with the investment credit provided in this section? In the first place it is highly selective as to the type of investment which may qualify and as to the time when this investment must have been made. Individual air-conditioning units qualify but central air-conditioning systems do not; transient hotels qualify but residential hotels do not; cattle fences qualify but the cattle themselves do not. How are we to make sense out of a provision which substitutes the Federal Government's wisdom for that of the private sector in ascertaining what type of investment is required for the economic health of individual business enterprises? Not only does the section differentiate between types of assets, but it also makes an arbitrary determination, based on the expected life of the asset, as to how much, if any, credit will be allowed.

Furthermore, the credit discriminates between investment undertaken before and after July 1, 1962, in effect rewarding those business concerns which have for one reason or another failed to modernize and to expand prior to the effective date of this section. How can we justify a plan which announces to one group of businesses that they invested too early and are, therefore, not eligible for the 7-percent credit while telling another that they have waited until the proper time, that they have waited until the Government can step in with a special inducement for technological developments?

Secondly, the credit would be granted for qualified investment irrespective of the plans or obligations of a particular business. This is most obvious in the case of public utilities but applies also to any firm which has faith in the dynamism of the American economy and in the stability of our political and social institutions. Many businessmen have commented that the tax credit would have slight, if any, effect on their investment plans. Considered in this light, section 2 is, in a sense, a windfall which would benefit some of our industrial giants, leaving smaller and depressed businesses in the same cash-shy position as before. In the final analysis new investment is

dependent not upon a taxsaving of perhaps 1 or 2 percent of a company's estimated income tax, but upon the company's expectations of profits through the marketing of its goods or services. Businessmen invest because they have reason to believe that they will sell. Most business witnesses indicated preference for accelerated depreciation, together with straight tax reduction.

The Treasury's new depreciation schedule which went into effect in July of this year is a step in the right direction and, in my opinion, should be carried even further.

There is near unanimity among leaders of both labor and management that the investment credit is unsound and ill-suited to the problem which it seeks to solve.

CONTROLLED FOREIGN CORPORATIONS

Provisions of this bill for taxation of controlled foreign corporations threaten to upset established business practices both at home and abroad at a time when economic conditions throughout the world are changing rapidly and when nations are attempting to reevaluate and redfine their trade positions. Testimony before the Finance Committee indicated that the competitive position of many American firms operating in foreign countries may be seriously jeopardized because of the uncertainty and because of the penalties in this section.

Many American corporations have established subsidiaries abroad in order to take advantage of business opportunities in an expanding international economy. Subsidiaries have been set up to protect old markets and to penetrate new ones. These actions have increased the domestic business of the companies, have created jobs for U.S. workers, and in the case of most firms have resulted in a dollar return to the United States from the oversea business in excess of the amount invested abroad.

Many changes have been made in this section of the bill since the administration's initial recommendation of last year. The original proposal was to eliminate tax deferral for all controlled foreign corporations except operating subsidiaries in developed countries.

The House-passed bill eliminated deferral for the so-called foreign-base company income of tax havens unless it was reinvested in less-developed countries, and for operating subsidiaries unless their income was reinvested in the same business outside of the United States or in a less-developed country. Now the Finance Committee has adopted amendments which would leave the tax deferral for manufacturing subsidiaries intact while continuing tax deferral for foreign-base company income only if it is earned, as well as reinvested, in less-developed countries. The committee also voted to include income from services within the definition of foreign-base company income and to permit deferral if certain minimum distributions are made to U.S. shareholders, according to a formula which takes into account the effective tax rate of the foreign country in which the subsidiary is located. Finally, tax deferral has been continued for companies which qualify as export trade corporations.

In addition to these fundamental changes, there have been a number of other modifications. The definition of controlled foreign corporations affected by section 12 has changed; the tax treatment of patents sold or transferred to foreign subsidiaries has changed; cor-

porations organized in Puerto Rico or possessions of the United States have been exempted; greater recognition of the losses of foreign subsidiaries has been provided; and there have been many other changes.

These changes improved the bill, but are of limited good and do not eliminate the basic difficulties which would result from the passage of this section.

Many American firms would suffer in trying to compete with foreign competitors which enjoy the tax advantages while locating where they will. Companies with contractual commitments or indebtedness abroad would face an uncertain future, as would companies which can sell abroad only through sales subsidiaries because their volume is insufficient to justify expenses of establishing and operating a plant. This section would, in fact, serve as an invitation to foreign countries to increase their taxes on American subsidiaries, as such taxes can be credited against the U.S. taxes.

In a broader sense, the controlled foreign corporations provision erects a barrier to the achievement of vital national objectives, namely the expansion of trade and an improvement in our balance-of-payments position. We cannot promote either of these related objectives through a restrictive policy which, in the hope of correcting tax abuses, slashes with a broad sword at America's oversea subsidiaries.

In addition, section 12 raises certain constitutional questions. Can the United States tax a corporation's income to the shareholder before it is realized by the latter? Does the bill discriminate between different classes of shareholders in contravention of the fifth amendment? Would the United States be acting in violation of treaty obligations with foreign nations?

There are controlled corporations which have been established in foreign countries primarily, if not solely, for purposes of tax avoidance here in the United States. It is also true that some of these subsidiaries probably serve no real purpose as far as the interests of the United States are concerned. We should not throw the baby out with the bath water but should reconsider the means by which we undertake to correct abuses.

The fact that this section as originally proposed by the Treasury has been changed drastically in the House and Senate suggests strongly that this approach to oversea income is far too complex in its administration, far too selective in its application, and far too uncertain in its effects.

WITHHOLDING

The Senate Finance Committee eliminated the section which imposed withholding tax on interest and dividend income. This section had been proposed as a means of collecting a substantial portion of the estimated $850 million per year of taxes on interest and dividend income which, either because of ignorance of the law or dishonesty, is not paid. On the proposition that every person should pay his just taxes there can be no disagreement. The proposition, on the other hand, that to achieve this objective we should shift the burden of collection from the Government to the private sector of the economy and create unprecedented administrative complexities is, I believe, open to serious challenge.

Withholding on wages cannot be compared directly with withholding on interest and dividends. The former is imposed on the principal source of income for the vast majority of Americans. In most cases

an individual derives his wages or salary from a single source rather than from several sources as in the case of many taxpayers who receive interest and dividends. Even though our law provides for withholding from zero to 18 percent on wages and salaries, according to income and exemptions claimed, there has been overwithholding on as many as 40 million returns in a single year. In the case of interest and dividends, where a flat 20 percent would be withheld, we could expect overwithholding, in proportion to the number of returns with taxable income from these sources, to be considerably higher than overwithholding on wages and salaries. The quarterly refund and exemption certificate procedures included in the House bill would not alleviate the hardship and inconvenience created for many taxpaying citizens and institutions, and would, of course, complicate still further an already difficult administrative task.

One of the time-honored criteria of a good tax system is administrative simplicity and ease of compliance. The proposed withholding tax, with its exceptions and complications, would burden payors, recipients, and the Government itself. The collection of withholding on interest payments would be especially difficult because of the large number of small accounts, but similar difficulty exists with reference to dividend payments. Estimating tax liability and determining the exempt or nonexempt status of each interest and dividend recipient, knowing when an individual's status may change and adjusting his records accordingly, learning which types of payments are exempt, applying credits for individuals, governmental units, and tax-exempt organizations—these are among the many problems which would arise. Plans to apply the withholding tax more selectively, either by exempting persons with annual incomes of $5,000 or less or by exempting payments of $10 or less per year on any one account, would introduce additional complexities.

It appears that attempts to introduce equity into withholding only complicate its administration, while attempts to ease administrative problems would only result in serious inequities.

There is good reason, I believe, to expect much improved compliance in the future with existing tax laws, partly because of a public information program on the part of business and Government. Automatic data processing will soon be in operation and should help the Government to enforce tax laws while standing as a modern, mechanical reminder to taxpayers of their obligations. Section 19 of this bill now requires interest and dividend payors to report to the Government all payments of $10 or more during the year and to furnish each such recipient with a statement of his aggregate amount of payments. The Federal Government has required that every person who files a tax return be assigned an identification number which shall appear on all of his tax documents. Perhaps the Internal Revenue Service may even devise an improved tax form which would give greater prominence to interest and dividend income.

Together, all of these should add up to much improved reporting of interest and dividends and improved collections. Certainly for the sake of the taxpayer, businessmen, and the Internal Revenue Service, these methods should be tried more thoroughly. Only if these efforts and methods prove inadequate after fair and full trial, should withholding methods be applied.

Eugene J. McCarthy.

DISSENTING VIEWS OF SENATORS FRANK CARLSON, WALLACE F. BENNETT, JOHN MARSHALL BUTLER, CARL T. CURTIS, AND THRUSTON B. MORTON ON SECTION 11—FOREIGN SOURCE INCOME, H.R. 10650, AS AMENDED BY SENATE FINANCE COMMITTEE

The provisions for the taxation of foreign source income as set forth in sections 11 and 15 of H.R. 10650 as reported to the Senate are truly amazing. Eleven volumes of hearings by the Committee on Finance have been published since April 2, 1962. They include the testimony of 200 witnesses and statements by 300 additional taxpayers. In spite of virtually unanimous opposition by witnesses from industry, agriculture, the accounting and legal professions, and distinguished academicians and economists, these amendments are now before the Senate. The enactment of these provisions will produce no appreciable revenue, will have an ultimate adverse effect on our balance of payments, will discourage U.S. foreign investments, will hamper our export trade, and will invite retaliation and generate friction with our friends and allies. If the provisions of these sections are enacted into law, normal trade relations will be seriously disturbed.

There is a serious question as to the constitutionality of the basic concept of taxing the earnings of foreign subsidiaries which have not been constructively received by U.S. taxpayers.

Section 11 proposes that a tax be imposed on increase in net worth which has long been held unconstitutional. If such a theory is accepted as proper, there is no reason why every stockholder would not be assessed a tax on the increase in the value of his security during any given period of time, whether such an increase has been a taxable gain or not.

Section 11 completely disregards corporate legal entities, legitimate in purpose or otherwise. It disregards the spirit, if not the letter, of existing tax treaties and conventions which have taken years to negotiate by both Republican and Democrat administrations. It provides for a tax on imputed income. If a U.S. domestic taxpayer has not received funds to pay this tax, it must be paid by reducing the availability of funds for employment or investment in this country.

It encourages U.S. direct investment in foreign securities rather than in U.S. owned and operated foreign subsidiaries. Clearly such investments will reduce America's competitive position in world markets and in all likelihood will have an additional adverse effect on our short and long term balance of payments position.

It imposes an unfair competitive burden on foreign subsidiaries of U.S. corporations, since no foreign government imposes similar taxes on local competitive enterprises. It establishes undue hardships resulting from differences in accounting practices employed by foreign versus U.S. companies. Section 11 provides that the accounting

practices applicable to domestic corporations shall govern the determination of foreign source income on which a tax is to be levied. Necessarily, in most instances this will require the maintenance of two sets of books and accounts—one to meet the needs of the foreign operation and the second to determine U.S. tax liabilities. This procedure will impose unwarranted costs on many small enterprises. Furthermore, if a subsidiary has a substantial foreign minority interest, the entire cost of duplicate records will have to be borne by the domestic, parent corporation, thus reducing its income and tax liability to the Federal Government. It would create a powerful incentive to the governments of foreign countries to levy special taxes on the income of subsidiaries of U.S. companies.

Necessarily the determination of subpart F "income" includes the conversion of foreign earnings into dollars at the existing rate of exchange which may be favorable or unfavorable at the time. If a tax is paid to the Federal Government by the U.S. parent corporation and at a subsequent date the exchange rate between the dollar and the foreign currency is changed, there is no recourse by the U.S. parent corporation for the unjust enrichment to the U.S. Government.

Furthermore, the language contains unprecedented delegation to the Secretary of the Treasury or his delegate to prescribe by regulation concepts which should be embodied in substantive legislation itself. The delegations leave so much to administrative fiat that they represent an abdication of congressional authority over taxation. By their terms, they warn business that the tax burden is subject to change by administrative decree. This fact alone inhibits orderly planning and makes the risks of capital investment abroad very uncertain.

There is also the possibility that in some instances American interests in foreign operations will be transferred to foreign firms because of their inability to finance the payment of these additional taxes. Such an eventuality would greatly weaken the U.S. competitive position in world markets.

Section 15 "Sales and Exchange of Patents to Certain Foreign Corporations" as reported to the Senate once again abandons long established practices and discriminates against American corporations doing business abroad. It would tax the sale and exchange of capital assets in a different manner than they are taxed in domestic transactions. Since the proponents of this legislation have stressed the need for neutrality of taxation on foreign and domestic activities, these discriminatory provisions clearly show that neutrality is not provided in this proposed legislation.

The enactment of these provisions will be bewildering to American business and to the Internal Revenue Service itself. They will foster serious litigation and demand court interpretation before the true meaning of the language reported by the committee can be applied to actual business transactions.

THE ADMINISTRATION'S OBJECTIVES

President Kennedy first presented his tax recommendations to the Congress on April 20, 1961. They included basic changes in the concepts for the taxation of foreign source income. His message suggested that existing law which does not tax the unrepatriated earnings of foreign subsidiaries had played an important role in

recent years but that it should now be abandoned. The President stated that:

> Changing economic conditions at home and abroad, the desire to achieve greater equity in taxation, and the strains which have developed in our balance of payments position in the last few years, compel us to examine critically certain features of our tax system which, in conjunction with the tax system of other countries, consistently favor U.S. private investment abroad compared with investment in our own economy.
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> * * * Many American investors properly made use of this deferral in the conduct of their foreign investment. Though changing conditions now make continuance of the privilege undesirable, such change of policy implies no criticism of the investors who so utilize this privilege.[1]

It should be noted that the President clearly stated that he did not regard the so-called principle of deferral as an improper practice or a form of tax evasion. However, there is an implication that so-called deferral represents a privilege, and is a relatively new concept in our tax laws and perhaps was enacted in order to promote the aims of the European recovery program under the Marshall plan. This is not a fact, as the basic concepts of taxation applicable to foreign-source income have been included in the Internal Revenue Code since its inception in 1913. Furthermore, they are found in the tax laws of every other country.

Secretary Dillon, in his appearance before the House Ways and Means Committee, in May 1961, advocated the elimination of deferral in developed countries as he believed such action would further several desirable objectives. They included the improvement of our balance-of-payment position, increased U.S. tax revenues, the achievement of "tax neutrality," which, in turn, he suggested, would result in additional domestic employment by the promotion of added exports and encouragement for additional investment in the less-developed countries of the world.

Extensive hearings were conducted by the Ways and Means Committee, and representatives of every sector of the business community appeared in opposition to this marked change in the concept of taxation. Their testimony clearly showed that the operation of foreign subsidiaries promoted our exports, and that the balance-of-payments position had been favorably affected by the existence of direct foreign U.S. investments. In fact, Secretary Dillon conceded that after a period of approximately 17 years, our balance-of-payments position would be damaged by discouraging any further direct U.S. foreign investment as the administration recommended. When such changes are proposed, there must be compelling and convincing reasons.

U.S. direct foreign investments total more than $50 billion. They constitute one of the Nation's most valued assets. If, as a result of the enactment of this measure, foreign investments by American firms are discouraged, the economy of this country will be adversely affected.

The testimony presented before the House Ways and Means Committee clearly showed that over the 15-year period ending in 1960,

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[1] President's 1961 Tax Recommendations, hearings before the Committee on Ways and Means, House of Representatives, 87th Cong., 1st sess., vol. 1, p. 8.

receipts from direct investment exceeded current outflows by nearly $10 billion. Certainly this data does not support the contention that foreign direct investments adversely affect our balance of payments.

The testimony also showed that the taxes levied on the remittance of dividends to U.S. parent corporations on their direct oversea investments have been a substantial source of income to our Government. The witnesses who appeared showed that it was impossible to accomplish "tax neutrality" in the sense advanced by the administration. True neutrality must respect the business facts of life and insure that competition may take place on a basis of neutrality in the marketplace.

The Congress of the United States cannot determine the tax laws that will be applicable in other countries, not only with respect to their own nationals but to those of other countries as well.

Furthermore, the hearings before the Ways and Means Committee clearly showed that there was no basis to support the contention that by restricting investments overseas, additional investment would occur in the United States—thus providing employment opportunities for our people and increased exports. On the contrary, the testimony indicated that virtually every U.S. firm would prefer to operate entirely within the jurisdiction of the United States, and export its production to world markets. However, a multitude of reasons have necessitated the establishment of foreign operations if the United States is to enjoy its share of participation in foreign markets. U.S. firms are confronted with a choice of either abandoning these markets or of establishing appropriate facilities to meet the competition already present or which is expected to be established to penetrate such markets.

The concepts originally advanced by the administration in 1961, with modifications to meet the more obvious discriminations, are the basis for H.R. 10650 as reported by the Committee on Finance. While this measure is still supported as a means of providing what the administration chooses to call "tax neutrality," it is quite apparent that no enactment by the Congress could achieve this result.

Our citizens should be in a position to compete in any country of the world with the nationals of other developed nations. Such competition may take the form of exports from the United States, licensing of patents and processes to a foreign firm, or the operation of manufacturing and distribution facilities in foreign countries. The decision as to the best combination of business activities must be determined on the basis of all of the factors involved in a given market as well as whether firms established in other nations are free to make what, to them, appears the most desirable economic choice. It is a disservice to place American firms in a position where their freedom to compete is restricted.

Contrary to the views advanced by the administration, American business does not go abroad because of a more favorable tax climate, but because on the basis of business judgment, it appears that a profit can be achieved by establishing a foreign operation. Business is rarely confronted with a choice of exporting or operating abroad. It is rather the choice of whether to abandon a market entirely or to seek a competitive position therein. In spite of the refutation of the arguments advanced by the administration, the House of Representatives passed H.R. 10650.

The preponderance of the evidence presented to the House Ways and Means Committee and to the Committee on Finance clearly shows that none of the objectives the administration is seeking to achieve would be furthered through the enactment of its proposals with respect to the taxation of foreign-source income.

HEARINGS BY THE COMMITTEE ON FINANCE

Section 13 of H.R. 10650, as passed by the House of Representatives, did not completely eliminate the administration's so-called tax-deferral privilege. Accordingly when the Committee on Finance started its hearings on April 2, the administration once again urged that its original proposals for complete deferral be accomplished by amendments to H.R. 10650. Secretary Dillion stated that:

> H.R. 10650, as passed by the House of Representatives, apart from tax havens, deals only peripherally with tax deferral for foreign income, another important tax preference now accorded foreign, as compared with domestic, corporate income. It responds to the President's recommendation in this area only insofar as it specifies that the undistributed foreign income of U.S. subsidiaries operating abroad will be subject to U.S. tax, as it is earned, unless it is reinvested in substantially the same trade or business already conducted by the firm in question, or in a less-developed country.
>
> By not treating the tax-deferral issue fully and directly, the bill still retains a substantial tax advantage for investment abroad rather than at home. The privilege of deferring U.S. taxes until income is repatriated as dividends should simply be eliminated for our subsidiaries in advanced industrial countries, as the President has requested. The deferral privilege should be retained, for income earned in less-developed countries, in line with our general foreign policy objectives.[3]

The Secretary endeavored to develop the need for this legislation. He stressed that it would serve two purposes: The first, an improvement of our balance-of-payments position, and second, it would contribute to Federal revenues. However, as the hearings proceeded, several major inconsistencies in the administration's position were developed.

The testimony which had been presented before the House Committee on Ways and Means clearly established that U.S. direct investments had generated a return flow of capital over the past 15 years that was a major factor in preventing a serious balance-of-payments crisis. Nevertheless, Secretary Dillon advanced a new concept by conceding that while the overall balance of payments on all U.S. direct investments abroad was favorable, the return flow on new investments was insufficient in comparison with the current outflow. He testified as follows:

> Now, certainly, we agree that if the investment is profitable, if it works well over the long term, it should begin to return funds back home and should return enough to offset

[3] Revenue Act of 1962, Hearings Before the Committee on Finance, U.S. Senate, 87th Cong., 2d sess., on H.R. 10650, pt. I, p. 99.

> the outflow, and should be an asset. That is why we believe in foreign investment, and it should be made in years when you have substantial surpluses, and it should be there to help you in years when you have deficits in your balance of payments. * * *
>
> Now, many of the statements that were made last summer before the Ways and Means Committee, which were made after our original presentation, did make it appear that this investment was profitable for balance-of-payments purposes sooner than we think is the case. But the big problem there was that they always compare, every time that I have seen it, the income that is received from investments that have been made over the past 10, 15, or 20 years, with the immediate dollar that goes overseas, and actually that is not a relevant comparison.
>
> At the moment, the facts are that we have a total investment overseas of about $50 billion, and we are getting a net return out of the investment—compared to the net against the new investment that has gone overseas—a net return of about $200 million, and that is much too small at this time.
>
> We think this is a time when we should be getting some net benefits in our balance of payments from our investments overseas.[3]

A number of observations are in order with respect to these statements. The formation of the European Economic Community has built a common external tariff barrier around a rapidly expanding market. This has forced U.S. firms to establish new operations within the Community. This single fact accounts for the large outflows to Western Europe during recent years. A single transaction involving the purchase of a foreign interest in the subsidiary of a U.S. firm accounted for a very large portion of the total outflow to Western Europe during 1960. It is idle to suggest that any new investment could possibly generate a return comparable to the investment itself within a few years after its establishment.

It appears strange that the administration would jeopardize the long-term benefits in order to provide a temporary correction of the short-term imbalance. The mere fact that the Secretary of the Treasury concedes that within a comparatively few years, new investments will make substantial contributions to our balance of payments, makes his position untenable. If the $50 billion of foreign investments overseas were not in existence, our present balance-of-payments problem would be acute. If the policies of taxation advanced by this administration had been adopted by the Congress a few years ago, this national asset would not be in existence. Should the Congress follow the Secretary's proposal, it will certainly not continue to grow and provide a greater positive factor in our overall balance-of-payments picture.

It appears likely at this time that for many years to come, perhaps for a generation, there will be a continuing need for foreign assistance and the military support of our allies to prevent further Communist aggression. In this context, the long-term needs of our economy extend far beyond the period that would be benefited by an immediate

[3] Ibid., pp. 447–448.

improvement in our balance of payments. However, the inconsistency in the Secretary's position with respect to the effectiveness of his proposal to eliminate tax deferral as a means toward the correction of an adverse balance of payments is shown in his statement before the committee on April 2. He said:

> * * * Insofar as taxation is concerned, our foreign subsidiaries at most would feel the effect of elimination of the deferral privilege only through a reduction in retained earnings. If this portion of the retained earnings is needed in the business, the parent can pay the U.S. tax or supply the additional needed capital in other ways.[4]

If the U.S. parent pays the tax from domestic sources, there will be no effect on our balance-of-payments position. But capital which would otherwise be available to expand domestic investment in the private sector of our economy would be diverted to the public sector. Clearly the improvement of our balance-of-payments position cannot justify the enactment of section 11 with the many serious consequences to our overall world trading position it would entail.

The Secretary of the Treasury in his first appearance before the Committee on Finance on April 2 continued to stress the need to enact legislation to provide additional revenues. Yet the real impact of the administration proposals with respect to the taxation of foreign source income is revealed in the following colloquy between Senator Carlson of Kansas and the Secretary of the Treasury:

> Senator CARLSON. I know you expressed your concern about our balance of payments. Is it not reasonable to assume that this legislation we are considering today is most important in our balance of payments rather than in the collection of taxes?
>
> Secretary DILLON. I think that of the two elements involved here in the foreign field, that the most important one probably—it is difficult to say which is the most important one—but vitally important is, first, the balance of payments, as you say; and the other thing that is vitally important is the general principle of tax equity, with respect to the abuse of these foreign tax havens which has become a scandalous thing. It is not that everybody who uses them should be stigmatized that way, but they have been very seriously abused, and that is the second major reason they should be prohibited.
>
> The third reason only is the extra revenue that will be obtained for the Government from that. I do not think it is tremendous compared to our overall revenues.[5]

It has long been the accepted view that the primary concern of the Congress in levying taxes is to provide funds for the operation of the Federal Government. If a complex measure which will impose burdens on most business enterprises with oversea activities and which will also complicate our international relations will not make a tremendous contribution to our overall revenues, it is strange that the administration would seek to secure the enactment of such provisions under these circumstances.

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[4] Ibid., p. 102.
[5] Ibid., p. 449.

In short, the hearings before the Committee on Finance developed the same philosophy and facts as had been presented a year before to the House Committee on Ways and Means. No convincing evidence was presented to substantiate the view that the administration's proposals could either ultimately improve our balance-of-payments position or contribute substantially to the Federal revenue. Nevertheless, the administration has continued to seek approval of a new concept to impose a tax on the unremitted earnings of foreign corporations to American shareholders.

In order to secure the acceptance of this principle, the amendments incorporated in the present version of section 11 do not deal with tax deferral as stringently as section 13 of the bill which passed the House of Representatives. The administration has abandoned its efforts to seek the complete elimination of tax deferral as proposed by the Secretary of the Treasury on April 2. It is now prepared to accept a measure which permits deferral on operations conducted within a given country and even on a portion of what were considered base company earnings such as sales and management activities. Clearly, the issue before the Senate is not the correction of our balance-of-payments position nor the provision of revenues, but rather the acceptance or rejection of an unsound and unwise principle of taxation, which if adopted in the pending bill will establish a precedent for the extension of such a principle into countless other areas. This measure could have no significant impact on either our revenue nor our balance-of-payments position. It cannot promote exports nor contribute to the attainment of any of the objectives outlined by the administration in its original message on taxation to the Congress in 1961. On the contrary, the uncertainty and confusion which even the discussion of these proposals has engendered, deterred some worthy foreign investments. Insofar as direct foreign investments support exports, the continued efforts to secure the enactment of this legislation are a disservice to our citizens whether they be investors or employees seeking broader opportunities. Our farmers and miners, whose economic position is directly effected by the strength of our overall efforts in world markets also have a vital stake in this matter. It is apparent that many of our citizens are confused with respect to the impact of the proposed legislation on our domestic economy. Nevertheless, the testimony from every sector of the business community clearly shows that if these concepts are enacted into law, the welfare of our own citizens who may not realize they have a stake in direct foreign investments will be adversely effected.

COMPLEXITIES OF SECTION 11

The language proposed by the Committee on Finance in section 11 "Controlled Foreign Corporations" is unnecessarily complex and confusing. The attempt to impute an amount to be included in the gross income of U.S. shareholders based on the earnings of controlled foreign corporations necessarily presents difficulties that repeated amendments have been unable to clarify. The Congress under the Constitution is responsible for the enactment of legislation which clearly defines the tax obligations of our citizens. The substantive determination of tax liabilities should not be delegated to the executive branch of the Government.

Section 11 provides that many substantive matters are to be determined by the Secretary of the Treasury or his delegate. The number of instances in which the Congress would abdicate its constitutional responsibilities by this delegation of power suggests that the concepts underlying this proposed new section of the Internal Revenue Code have not been clearly defined and perhaps can never be so defined. The requirement that the determination of the earnings of controlled foreign corporations follow the concepts of the U.S. tax laws is unrealistic, since these corporations operate under the laws of other nations and the tax credits, the rules for depreciation, and numerous other basic concepts differ widely from the U.S. law and the rules and regulations for its implementation prescribed by the Secretary of the Treasury. Furthermore, earnings are computed in foreign currencies and the apportionment of the U.S. parent corporation's share of such earnings requires their conversion into dollars at an arbitrary value. The language in the proposed amendment does not provide for the return to the taxpayer of any taxes that were paid on unrepatriated earnings that subsequently could not be realized in equivalent dollars because of currency devaluation or other factors operative after the assessment of the U.S. tax. The language in section 964, subsection b, "Blocked Foreign Income," provides:

> (b) BLOCKED FOREIGN INCOME.—Under regulations prescribed by the Secretary or his delegate, no part of the earnings and profits of a controlled foreign corporation for any taxable year shall be included in earnings and profits for purposes of Sections 952, 955 and 956, if it is established to the satisfaction of the Secretary or his delegate that such part could not have been distributed by the controlled foreign corporation to United States shareholders who own (within the meaning of section 958(a)) stock of such controlled foreign corporation because of currency or other restrictions or limitations imposed under the laws of any foreign country.[6]

However, it fails to grant relief for taxes paid prior to the time that earnings could not be transferred. Furthermore, the assessment of a tax unrepatriated earnings insures that the U.S. Government derived revenue even though such earnings are based on accounting procedures which anticipate levels of activity for future income which may not be attained.

The burden of maintaining the records and accounts provided in subsection C of section 964 will impose additional costs on domestic parent corporations, as in almost every instance it will be necessary to maintain duplicate sets of records and accounts—one, to conform with the accounting procedures of the foreign country in which the operation takes place, and the second, for the computation of U.S. tax liabilities.

These activities do not contribute to the productivity and growth of our economy. They are a luxury that we cannot afford at this critical juncture in world history.

The committee received testimony on behalf of a distinguished group of New York attorneys who are specialists in matters involving taxation.

[6] H.R. 10650, 87th Cong., 2d sess., sec. 964, subsec. b.

Mr. Robert J. McDonald, a member of the group testified that:

> We believe, however, that the present bill does not effectively distinguish between avoidance devices and legitimate business operations conducted outside of the United States.
>
> Further, we believe the foreign income provisions are unworkable, are unduly penal in their impact on the foreign business of the U.S. persons, and may have many consequences that are clearly adverse to the interests of the United States.
>
> The foreign income provisions are unworkable because they are so complex that they cannot reasonably be understood or administered, and because their application depends upon detailed historical and current information that will often be impossible or impractical to obtain.
>
> They are unduly harsh and, in many cases, penal in effect in imposing burdens of taxation and of administrative compliance that are much more extensive than in the case of domestic operations, particularly in their impact on the individual foreign investor. Moreover, no opportunity is provided to adjust legitimate business arrangements established in reliance upon existing law and, indeed, at the urging of our Government.
>
> These provisions would have numerous consequences that are clearly undesirable and often unintended. The substantially favor foreign competitors who are not subject to similar burdens, even though the committee report notes that one of its guiding policies is to avoid weakening the competitive power of American business abroad.
>
> Now, in determining the pro rata share of a corporation's increase in earnings invested in nonqualified property, not only must there be a determination of the earnings and profits for the year and the earnings and profits accumulated since December 31, 1962, but there must also be a review of the financing business needs and underlying nature of the business of the foreign corporation and of any changes made therein.
>
> To make these determinations requires the application of a series of imprecise concepts, and the availability of information extremely difficult to obtain.
>
> The determination of earnings and profits for the year or for the period since December 31, 1962, of foreign corporations presents problems which will be insurmountable in a substantial number of cases.
>
> These determinations are dependent not only on U.S. concepts of tax accrual, tax deferments, tax elections, basis, tax exempt income, amortization and depreciation, and numerous other items completely alien to the foreign corporations and foreign accountants, but it is also affected by reorganizations, liquidations, exchanges, and distributions in kind which may or may not be tax free by American standards.

> There are no provisions whatsoever under the bill for making these determinations or provisions establishing the machinery therefor.[7]

The statement presented to the committee on behalf of these attorneys by Mr. McDonald included numerous examples to show the possible undesired consequences of enactment of the administration's proposals. The statement included a section on the unworkability of the bill which suggest that the Internal Revenue Service will be confronted with the same difficulties that were perceived by these attorneys in their examination of these provisions. Mr. McDonald stated:

> The bill's provisions in respect of foreign income are so complex, overlapping, and replete with unprecedented tests that it is difficult to analyze them. The members of this group submitting this report are experienced in matters of tax law; they have spent over 40 hours in group discussion and countless hours of individual study reviewing the contents of the aforementioned sections. Despite this, the practical problems of working with the proposed legislation are so immense that the group has found it difficult to understand the bill and impossible to measure its full impact. So many new concepts are included in the bill that a definite technical analysis by tax practitioners has been virtually impossible. The complexity of its provisions can only cause uneven and arbitrary enforcement and administration of the bill. Skilled tax practitioners will undoubtedly find technical loopholes. On the other hand, many U.S. entrepreneurs will by chance find themselves caught by extremely harsh provisions of the bill which by proper planning could have been avoided. Revenue agents cannot be reasonably expected to understand the provisions or to enforce them uniformly. Thus, the impact of the bill will be haphazard.[8]

In view of the fact that the enactment of section 11 will make no significant contribution to Federal revenues nor will it improve our balance-of-payments position, it is inconceivable that the Congress would enact legislation which contains so many ill-defined, complex, and conflicting provisions.

ADVERSE EFFECTS

Many witnesses who appeared before the Committee on Finance expressed concern at the serious and unintended adverse effects which the enactment of this legislation would produce.

Mr. Leslie Mills, chairman of the Committee on Federal Taxation of the American Institute of Certified Public Accountants, testified that:

> Not the least of the evils which would plague business if these sections are enacted is the authority given to the Treasury Department to make unilateral determinations affecting the tax burden of the domestic corporation. In

[7] Revenue Act of 1962, Hearings Before the Committee on Finance, U.S. Senate, 87th Cong., 2d sess. on H.R. 10650, pt. 7, pp. 3137, 3139.
[8] Ibid., pp. 3147, 3148.

many provisions authority is given to the administration, including the Treasury Department, to make unilateral determinations, from which no appeal appears possible. As one example, a formula is provided for allocating income under certain circumstances, with a further provision that intercompany prices may be determined on an arm's-length basis. However, determination of the arm's-length character of transactions is subject to rather rigid rules which may not give effect in every case to all of the pertinent factors. Moreover, if such arm's-length determinations by the taxpayer are not satisfactory to the Treasury Department, that Department through its agents can determine the allocations which in its sole judgment are proper, without any opportunity for an impartial appraisal. This, and similar approaches to these most difficult problems leave American business operating abroad entirely at the mercy of our bureaucracy. This uncertainty alone will surely cause American business to restrict operations abroad. It certainly creates no climate for new expansion. * * *

I have endeavored to point out that the complexities in this area, and in other parts of the bill, are by themselves serious. The very existence of uncertainties hampers business. Adding these complexities to the already complicated problems of doing business abroad will have the effect of discouraging many small businesses from expanding into the international trade area. The legislative history of the bill in the foreign income area emphasizes this important problem. Business enterprises have been forced to consider a regular series of proposals in the foreign area throughout the past year, and each one has required the immediate initiation of planning to avoid the severe and haphazard penalties which would be incurred under their present organization and manner of doing business. The latest proposals are only a few weeks old, and it cannot be expected that the picture is at all clear for the many organizations, large and small, which will be vitally affected. Yet the most basic provision, with respect to income of controlled foreign corporations, would become effective less than 9 months from now, and presumably just a few months after the final form of the provisions are known if they are approved by the Congress. The far-reaching provisions concerning liquidation and sale of stock would become effective upon enactment. At the very least, therefore, businesses should have more time to turn around and reorganize their activities to avoid possible destruction of their interests. It seems particularly inappropriate to legislate such far-reaching, new, and untried concepts in our tax structure at the very time when the Treasury Department is on record as preparing to release in the near future proposals for a basic reform of the tax structure.[9]

[9] Revenue Act of 1962, hearings before the Committee on Finance, U.S. Senate, 87th Cong., 2d sess. on H.R. 10650, pt. 2, pp. 546, 547.

Another witness, Mr. Tyrone Gillespie, assistant to the president of the Dow Chemical Co., in his testimony stated:

> If the foreign income concepts are enacted into law, our company and all other companies similarly situated will be faced with the severe problem of trying to determine whether the accounting principles and methods of our foreign subsidiaries are compatible with those in the United States, and whether in those cases where we have less than 100 percent ownership, it would be possible to do so in fairness, or at all, without full concurrence of other stockholders. In any case, it would be necessary to maintain two sets of records, one to comply with foreign law and one with U.S. law, and there is a question as to where such records should be kept.
>
> In order to comply with U.S. law, much of the information will have to be estimated because data are not available under foreign accounting systems, and certainly companies will have a built-in and continuing argument with the Treasury Department as to whether their estimates are proper or improper. We are certain that the committee is cognizant of the vast enforcement costs which will be entailed for worldwide policing most of which will gain little revenue so we will not elaborate on this point.
>
> Another question which gives us concern is our company's position if we disclose certain data and economic information of a company in a foreign country in which we are a part owner, where the laws of the country prohibit such disclosure. Does this U.S. law force us to commit economic espionage and thereby render us liable under the laws of our host country? [10]

The uncertainty alluded to by the two witnesses just cited presents a serious problem not only for the business community but for the Congress, as indecision by responsible management at this time can result in a slackening in our economy growth and a failure to provide adequate job opportunities for our growing labor force.

Furthermore, such uncertainty will not only adversely affect the earnings of business enterprises but will result in a decline in Federal tax revenues. Dr. Dan Throop Smith, professor of finance at the Harvard Graduate School of Business Administration and a former Assistant Secretary of the Treasury, posed a number of problems which may beset American business should this legislation be enacted. He informed the committee that he was undertaking a study of all the possible consequences of the pending tax legislation. He summarized his observations as follows:

> Many considerations are relevant to a decision on the taxation of foreign income. I know of no single area where it is so difficult to balance the conflicting objectives of policy.
>
> I have already written a fair amount on the subject, but in recent months have become increasingly interested and concerned with it. I have recently returned from a trip to Western Europe which I took, in connection with current

[10] Revenue Act of 1962, hearings before the Committee on Finance, U.S. Senate, 87th Cong., 2d sess. on H.R. 10650, pt. 8, p. 3667.

research activities, to determine attitudes and practices regarding the taxation of foreign income in some of the industrial countries there. I shall try to state here as concisely as possible what seem to be the most significant points, pending preparation of a longer article on the subject.

Foreign operating subsidiaries are in no sense artificial or unnatural legal entities. Contrary to many foreign holding companies, foreign operating companies are used as the natural and normal means of participating in a foreign economy.

They were used long before we ever had an income tax; in some instances they are required by foreign governments. They are necessary when joint ventures are developed with local capital. It is a misconception to think that they are established primarily for tax advantages.

Furthermore, operating subsidiaries abroad are in competition with other companies located abroad. American parent companies usually establish foreign subsidiaries to maintain a position in foreign markets or to secure a position in new markets.

They do not establish foreign operating subsidiaries as an alternative to expansion at home for production of export commodities. When foreign markets become large enough and foreign conditions for production good enough, production is going to take place abroad.

There are plenty of local companies able and anxious to expand to meet domestic requirements in foreign countries, and plenty of large corporations in other major industrial countries able and anxious to set up their own foreign subsidiaries, and active in doing so.

If our country is to get its rightful competitive share in the expanding income of the world, our business firms must be free to compete where production is taking place.

This point cannot be overemphasized. Someone is going to produce abroad; it is the very essence of economic development abroad that production will take place there. It is a serious misconception to believe that if American firms cannot produce abroad, no one will do so and that foreign demands will remain unsatisfied until filled by American exports.[11]

He further stated:

As markets grow with the rapidly expanding standards of living in the Common Market, it is important to be in on the ground floor, as it were, to have brand names known, to establish distribution channels, and to act promptly in improving products and processes.

If a company falls behind, it can catch up, if at all, only with increased outlays. If it tries belatedly to secure entry into an established market, it can probably do so, if at all, only at greatly increased cost.

[11] Revenue Act of 1962, hearings before the Committee on Finance, U.S. Senate, 87th Cong., 2d sess., on H.R. 10650, pt. 7, p. 3089.

These are familiar facts of business which I shall not elaborate, but they should not be overlooked if an argument is made that we need only temporarily to restrain investment, or that old investment is good but new investment is bad, because it is not immediately recouped in repatriated profits.

Business investment must be a continuing dynamic process; it it is not continued as required, the value of old investments, and the possibility of continued repatriated income from them, will wither away.

To the best of my knowledge, and I have inquired carefully, no other country in any way taxes their own companies on the basis of undistributed income of foreign subsidiaries.

Furthermore, on the basis of extensive inquiries in Europe in recent weeks, there is no indication whatsoever that other countries would follow our example. There is some concern abroad about prlcing on transactions between parent companies and foreign subsidiaries—the sort of problem covered by section 482—and in some instances about foreign personal holding companies.

But I found no indication that there was any concern about the undistributed income of foreign subsidiary operating companies or any likelihood that other countries would impose taxes on their own companies similar to those proposed here.

Nor does there seem to be any political controversy or even thought to the contrary on this subject. In one place when I asked if there were arguments to the effect that foreign subsidiaries might lead to a loss of domestic employment the answer was "No; it is recognized that we must have worldwide activities to support the cost of research and development to meet intense international competition. The ability to spread costs over the business of foreign subsidiaries helps assure continued domestic employment."

This reflects the same high degree of sophistication found in most ofthe European labor groups which support, instead of opposing, liberal depreciation as a basis for increased productivity, which in turn leads to higher standards of living and increased employment.

But though other countries will not follow our example in taxing their own corporations on the basis of undistributed income of their foreign operating subsidiaries, it seems very likely that they will be tempted to impose their own special taxes on the U.S.-owned subsidiaries located in their countries.

Does it not seem probable that on practical grounds if there is to be any extra tax on undistributed income of U.S.-owned subsidiaries, the countries where the subsidiaries are incorporated and where the earnings are located will want to exercise their primary right to tax them?

I was asked more than once in my recent trip, by Europeans if I did not think that the countries where the subsidiaries were located would adopt their own laws to secure for themselves the revenue to be derived by new tax burdens imposed by the United States on undistributed income of foreign subsidiaries.

> And, of course, I had to admit that I supposed they would.
>
> The actions of many of our States in imposing soak-up estate taxes to absorb the credit allowed in the Federal estate tax is a perfect precedent. The adoption of anything like section 13 will invite foreign countries to impose their own taxes and it seems likely that many of them will accept the invitation.
>
> To the extent that foreign countries do impose their own soak-up taxes, any expected revenue to the U.S. Treasury will disappear. Increased taxes imposed by our Congress would end up in foreign treasuries, not in the U.S. Treasury.[12]

The possibility of the imposition of new retaliatory taxes by foregin governments would completely destroy the efforts that have been constantly pursued to eliminate double taxation and other hardships which restrict the flow of commerce. It is difficult to reconcile the announced goals of the administration in the Trade Expansion Act of 1962 (H.R. 11970) with the isolationist views toward foreign investment encompassed in H.R. 10650.

A further possible adverse effect which is clearly unintended by the administration is the possible disposal of a sufficient interest in a presently controlled foreign corporation to the nationals of other countries so as to relieve the American parent of the burdens imposed by section 11. This would jeopardize U.S. control over many important trading and manufacturing activities which support our exports and employment in this country.

Again a colloquy between Mr. Robert J. McDonald, a New York attorney representing a group of tax lawyers, and Senator Kerr, of Oklahoma, is significant:

> Mr. McDonald. They encourage U.S. persons to take minority rather than controlling interests in foreign businesses, with the possible consequences, among others, of loss of a favored position with respect to the sale to such businesses of domestic products.
>
> Senator Kerr. Let me interrupt you there.
>
> Mr. McDonald. They encourage——
>
> Senator Kerr. I say, let me interrupt you.
>
> Mr. McDonald. I am sorry.
>
> Senator Kerr. You have just said that, in your judgment, this bill would encourage American investors to take minority positions in foreign corporations rather than American corporations creating subsidiaries in foreign areas.
>
> Mr. McDonald. We believe it might have that tendency.
>
> Senator Kerr. That was one of the points that Dr. Dan Throop Smith made with reference to the investment company which asked for the conference with him and discussed the probability of their increasing foreign stocks in their portfolios of investments, although they are American investment companies, I believe.
>
> Mr. McDonald. Generally speaking, an American investment company, assuming it is an investment company with

[12] Ibid., pp. 3090–3091.

wide distribution of its stock, would tend not to have a controlling position, and when I say controlling I mean more than a 50-percent interest in the foreign corporation.

Senator KERR. And to the extent that it encouraged investment in minority positions in foreign corporations, it would adversely affect our balance of gold payments rather than favorably affect them.

Mr. McDONALD. It may or may not. I think that is a complicated question. I think that——

Senator KERR. If a situation arose whereby Americans took American dollars and bought stocks from foreign owners and paid for them in American dollars that went over there, that would be adverse in our balance of payments, would it not?

Mr. McDONALD. Temporarily it might.

Senator KERR. Well, the only way that those dollars could come back would be for those sellers to send them back.

Mr. McDONALD. That is correct. And if you did not have controlling positions in those companies there would be less tendency for them to find their way back.

Senator KERR. It would seem to me you were making a point which, I think, is of some significance, and I was asking you the questions only to let the record clearly reflect that as your judgment, if that is your judgment.

Mr. McDONALD. I believe it is.[13]

During the course of the interrogation of Mr. Charles W. Stewart, who appeared in opposition to the administration's foreign tax proposals on behalf of the Machinery and Allied Products Institute, Senator Morton, of Kentucky, presented a hypothetical question which is a further cause for concern in connection with the Senate's consideration of this legislation. The colloquy between Senator Morton and Mr. Stewart follows:

Senator MORTON. Now, you talked to the point of constitutionality which we have dealt with in a rather cursory manner this morning.

I happen to be one of those rare Members of this body who is a businessman and not a lawyer. Sometimes I think the United States would be better off if we were more of us and fewer lawyers here.

As I see the situation in my lay mind, it is comparable to this: Let us suppose that a trucking company in Kentucky had 10 stockholders. Five lived in Tennessee and five in Kentucky.

Let us assume that they made $100,000 after taxes in 1 year. They decided they would pay $25,000 in dividends, that they would retain $75,000 in the business for the purpose of buying new trucks and expanding their operations.

The State of Tennessee has an income tax law. The State of Tennessee would say to those five Tennessee stockholders "but you must pay an income tax based on the earnings of this Kentucky corporation in which you own stock in the

[13] Op. cit., Revenue Act of 1962, pt. 2, p. 678.

> amount of four times what you paid because they earned $100,000 and they only paid $25,000 in dividends."
>
> Admitting that is an oversimplification, is that not to a lay point of view somewhat analogous to this constitutional question?
>
> Mr. STEWART. I think you are a much better lawyer than you admit, sir.
>
> I would say that you draw a point here that worries me beyond the scope of this bill.
>
> It seems to me we are breaking new ground if we go to the full route of these provisions in terms of applying the same principle to our domestic tax policy. I am quite concerned about it, and your example is ecompletely on the beam in that respect.[14]

There would be no difficulty in continuing to review other adverse situations which could be most damaging to our economy that were presented to the Committee on Finance by witnesses experienced in every sector of the American economy.

Friendly foreign countries are already concerned with the administration's proposal, and the record of the hearings includes a press account to the effect that President Chiari of Panama has advised President Kennedy that the administration's tax proposal represents "undue interference in the internal affairs of Panama."[15]

President Chiari also declared that the taxation of the earnings of Panamanian corporations on profits which have been unremitted is "almost equivalent to economic aggression."[16]

The Swiss too have expressed similar concerns.

The vagueness of the administration's concepts are illustrated by a colloquy between the Secretary of the Treasury and Senator Curtis of Nebraska.

> Senator CURTIS. * * * Will you define a tax haven company?
>
> Senator DILLON. What we have done is not to define a tax haven company specifically, but to define in effect a tax haven transaction. For example, a tax haven transaction is one where a company incorporated in country A purchases from country B and resells in country C.
>
> So in this situation there have to be three countries involved and the use of the words "tax haven company" is just a short description of companies which operate in this way. We do not have a definition of a company as a tax haven company.
>
> Senator CURTIS. I understand it is not in the proposal, but this is presented to the country and to this committee as reference to a tax haven company, and there are people in Congress and out that are concerned about tax haven companies.
>
> So, I would like to have a definition of the company you are speaking about when you use this term, not the name of the company but what constitutes a tax haven company.

[14] Op. cit., Revenue Act of 1962, pt. 2, p. 678.
[15] Revenue Act of 1962, hearings before the Committee on Finance, U.S. Senate, 87th Cong., 2d sess., H.R. 10650, pt. 1, p. 653.
[16] Ibid.

Secretary DILLON. Well, I have already given a definition to the Senator. It means companies that operate in the way I have described; that are domiciled in a country, generally a very low-tax country; that do business in two other countries. We can give you a list of names of these countries if you desire.

Senator CURTIS. Now, a tax haven company is one that does business with two other companies in two other countries. countries.

Secretary DILLON. What I have said is that in a tax haven transaction where there are two other countries involved, and one of them may be the United States.

It is also a transaction where income for a service, a commission for an item sold, a royalty for a patent, anything you wish, is received from one country by a corporation incorporated in another country.

Senator CURTIS. Now, are all such operations that you have described tax haven transactions?

Secretary DILLON. Not all such operations are necessarily tax haven transactions, and that is the specific reason why I requested in the statement I made yesterday that the Secretary of the Treasury be given authority to exempt specific transactions, specific operations that are not entered into for the purpose of tax avoidance.

I would say that three-quarters or 90 percent of the transactions that I have described are for the purpose of reducing taxes and would be tax haven transactions.

But there are some, and I can give you examples, which are not.

Senator CURTIS. Give me an example of one that is.

Secretary DILLON. One that is?

Senator CURTIS. Yes.

Secretary DILLON. A classic example of one that is, is a U.S. foreign subsidiary which has a manufacturing plant in England to make anything, condiments, if you will. It sells all its condiments that it sells on the Continent first to a U.S.-controlled Swiss sales corporation. They never go to Switzerland, but they are marketed in France, Germany, Belgium, everywhere else as the property of the Swiss sales corporation. The entire profit is lodged in Switzerland. The manufacturing company in Great Britain is paid a very small figure for the wholesale value and makes a minor profit.

That is the type of operation that clearly is a tax haven operation.

Senator CURTIS. Where does the U.S. Government come into the transaction you described?

Secretary DILLON. Where the United States comes in, in that transaction, is that these would be controlled foreign corporations the control of which is in the U.S. parent corporation.[17]

The complexities of transferring available funds from developed nations to investments in less developed countries will frustrate our

[17] Revenue Act of 1962, hearings before the Committee on Finance, U.S. Senate, 87th Cong., 2d sess., H.R. 10650, pt. 10, pp. 4309-4310.

foreign policy objectives of encouraging private investment to assume a larger role in economic development—thus relieving the taxpayers of a portion of this burden.

The Secretary of the Treasury in his appearance before the Finance Committee on April 2 expressed the view that tax haven operations constitute a serious abuse, and he urged the committee to amend the bill as passed by the House of Representatives to completely eliminate tax deferral on the undistributed foreign income of U.S. subsidiaries operating abroad. Shortly thereafter, the Secretary addressed the Ninth Annual Monetary Conference of the American Bankers Association in Rome, Italy, on Friday, May 18. He expressed a somewhat different view as to the nature of American oversea investments in his discussion of this subject before a foreign audience. He stated:

> The United States has consistently favored free capital movement the ability of individuals or companies to invest their funds where they will. There has been no change in that view. We are, however, asking our Congress to end the tax inducements to American investment in other industrialized countries, particularly the inducements which flow from the mushrooming use of so-called tax havens. The object is not to discourage capital from going abroad in search of higher gross return. That sort of investment will, in the long run, serve the investor, the United States, and the recipient country alike. We recognize that the great bulk of our foreign investment is of this type and is not tax induced. We do, however, want to make sure that our tax system does not unwittingly—and artificially—spur this outflow. We wish only to eliminate marginal foreign investment that is induced primarily by tax considerations. While there is no expectation that such action will dramatically reduce the outflow of direct investment funds from the United States, it will be of some help—and every bit counts in the effort to eliminate our payments deficit.[18]

The Secretary's statement shows that there is no need to risk the adverse effects that the passage of this legislation might entail, since he finds that the great bulk of our foreign investments is not tax induced and in the long run serves the investor, the United States, and the recipient country alike.

If the only concern of the Congress is to eliminate marginal foreign investment that is induced primarily by a tax consideration, then section 11 does not appear as an appropriate instrument to accomplish this end. Furthermore, the Secretary of the Treasury is on record at Rome that there is no expectation that the enactment of additional legislation will dramatically reduce the outflow of direct investment funds from the United States.

CONSTITUTIONALITY

Section 11 imposes a tax on U.S. shareholders of foreign corporations based on the earnings of such corporations even though there has been no constructive receipt of funds with which to pay the tax.

[18] Remarks of the Honorable Douglas Dillon, Secretary of the Treasury, Ninth Annual Monetary Conference of the American Bankers Association, Rome, Italy, May 18, 1962, p. 10.

The establishment of tax liabilities in this manner is a reversal of existing concepts which have been established for almost 50 years. It completely disregards corporate legal entities wholly legitimate in their business purposes.

The proponents of this theory of taxation attempt to justify it under the philosophy of the foreign personal holding company provisions. A colloquy between the Secretary of the Treasury, Mr. Dillon, and Senator Curtis of Nebraska is significant:

> Secretary Dillon. Under the philosophy of the foreign personal holding company provisions, the Congress has decided and the courts have upheld that where transactions are entered into for the purpose of avoiding U.S. taxes, the income can be imputed to the U.S. stockholders and that in effect is what is happening here.
>
> Senator Curtis. That is a personal holding company?
>
> Secretary Dillon. That is what it is by definition.
>
> Senator Curtis. I thought you were describing an actual operation of manufacturing and sale of goods throughout Europe.
>
> Secretary Dillon. There is no legal constitutional difference and we are following the exact same procedure here. We apply the same procedure to these other operations as has been applied for many years to foreign personal holding companies.
>
> Senator Curtis. But suppose that the parent company in the United States is a publicly held corporation and not at all in the category of a personal holding company, and it has many stockholders, is income either to the—is income to the subsidiary income to the stockholders of the parent corporation.
>
> Secretary Dillon. We look on a parent corporation as a U.S. person under the law, and the income is imputed to the U.S. person who controls the foreign subsidiary, and that person would be the U.S. parent corporation.
>
> Senator Curtis. Now suppose this company in this hypothetical case you describe was set up for the purpose not of evading taxes on income earned under the American flag but was for the purpose of finding a market, developing a market that could not be developed by the parent company located in the United States.
>
> Would that change the situation?
>
> Secretary Dillon. I certainly recognize that there are markets that can best be developed by investment abroad. But we do not feel that it is necessary to have as an added inducement and an added factor in that development the tax inducement of partial or complete tax exemption that flows from the use of tax havens. We think that the same markets could be developed by paying a reasonable tax.
>
> Senator Curtis. They do pay a tax when the money is brought back, do they not?
>
> Secretary Dillon. A tax is paid when the money is repatriated to the United States; that is correct.
>
> Senator Curtis. Now, speaking of operating companies that actually engaged in manufacturing, processing, selling,

all of that activity is outside the United States, isn't it true that heretofore we have adhered to a jurisdictional principle that a tax so earned outside of the United States—the U.S. tax on income earned outside the United States—is due when it is remitted to this country?

Secretary DILLON. That has been the principle in the law, except for the foreign personal holding company law.

Senator CURTIS. And this proposal would greatly change that wouldn't it?

Secretary DILLON. This proposal would very considerably modify that principle. That is the purpose of it.

Senator CURTIS. Now, you referred a moment ago to suggestions made yesterday to grant to the Treasury Department authority to by regulation—although you didn't use that word—except certain transactions or make a finding that they were not tax-haven transactions?

Now——

Secretary DILLON. That is correct.

Senator CURTIS. How is the business concern going to know what the rule of the Treasury would be 5 years from now?

Secretary DILLON. By coming in and asking.

Senator CURTIS. When? Now?

Secretary DILLON. Now.

Senator CURTIS. Would that answer be binding upon the Treasury 5 years from now?

Secretary DILLON. We would be prepared to give rulings on this sort of thing very generously ahead of time because we do not want to upset business and we don't want to have uncertainty here. We would be very glad for any business that thought it had a case to come in and talk to the Internal Revenue and we would give them a ruling in a proper situation.

Senator CURTIS. Well, I am glad you share the view that this is a decided change in the tax policy of the country.

One of the things I had in mind late yesterday afternoon when I requested that a new bill be drafted and printed as a study bill, study copy, was so that it could be examined, and to see what the proposal is made in our basic tax philosophy and practice in the light of your modified recommendations of your statement yesterday.[19]

It is inconceivable that the Secretary of the Treasury would suggest that exceptions to the law should be made on the basis of Treasury rulings so as not to disturb legitimate transactions.

The Foreign Personal Holding Company Act deals with passive investments that have no connection with the carrying on of an active trade or business.

The personal holding company tax was never conceived by the Congress as being applicable to the unremitted earnings of active overseas subsidiaries of U.S. business firms with widespread stockholdings.

[19] "Revenue Act of 1962," hearings before the Committee on Finance, U.S. Senate, 87th Cong., 2d sess. on H.R. 10650, pt. 10, pp. 4311-4312.

The National Foreign Trade Council was organized in 1914 to promote and protect American trade and investment. Its membership is comprised of manufacturers, merchants, exporters, importers, transportation interests, bankers, insurance underwriters, and many others interested in the expansion of the Nation's foreign commerce.

Mr. Joseph B. Brady, vice president of the National Foreign Trade Council, presented an extended legal brief to the House Committee on Ways and Means on June 5, 1961. It showed that the characterization of tax deferral as a privilege is a misleading one. It developed the history underlying the present U.S. tax laws, and it showed that the proposal to tax unremitted earnings is completely contrary to our established tax policies. It presents a serious question of the constitutionality of the administration's foreign tax proposals.

Section 13 of H.R. 10650 as it was referred to the Committee on Finance was based on the concepts to which the National Foreign Trade Council took exception in June of 1961. This organization again appeared before the Committee on Finance on April 25, 1962, and Mr. Brady again presented the legal reasons for the rejection of section 13 in the House measure. This section has been amended by the Committee on Finance and is now section 11 of H.R. 10650 as amended. The amendments adopted by the committee do not alter the underlying principles with respect to the taxation of unremitted earnings nor do they remove the constitutional doubts which were raised in the original brief presented to the House Ways and Means Committee. The legal reasons to reject any proposal to tax U.S. shareholders on the undistributed profits of foreign corporations contained in the statement presented to the Committee on Finance by Mr. Brady are worthy of the considered judgment of the Senate in its further deliberation on section 11 of H.R. 10650. These salient points with respect to legal and constitutional questions of this proposal follow:

> The legal reasons for rejecting the proposal to tax to the U.S. shareholder undistributed profits of foreign corporations, as provided by section 13, are discussed below.
>
> (*a*) *History and reasons for present law*
>
> The basic provisions of U.S. law, relating to taxation of income from foreign sources, have been in existence for nearly 50 years. All U.S. foreign investments have been made with these provisions as a background. In addition, important foreign investments have been made, under an announced policy of the U.S. Government, to encourage such investment.
>
> Under the 1913 act, income received by foreign corporations from sources outside the United States are not taxed. U.S. shareholders were taxed only on the dividends from such corporations. These basic provisions have been retained in all subsequent reenactments of the income tax law, including the 1939 and 1954 versions. Contrary to the impressions of some persons, no provisions were introduced into U.S. tax law after World War II to encourage investment and trade in Europe by U.S. companies.
>
> Like most features of tax law, these provisions reflect both theoretical and practical considerations. These considera-

tions generally fall either within the fiscal area, or the combined area, of public policy and trade. The recognition of the importance of foreign trade and investment, a recognition that income from foreign source is initially subject to tax in the foreign country, and the need for revenue, all form a part of the background for the enactment of our tax laws on income from foreign trade and investment.

The concept that a corporation is an entity, separate from its shareholders, has always been recognized as a fundamental in every phase of the law. The principle of the nontaxability of the shareholder on the undistributed income of a corporation has been one of the pillars on which our tax system has been constructed. In addition, considerations of international law and comity, as well as U.S. constitutional and administrative problems, are among the wide variety of factors that have affected the formulation of the basic U.S. tax provisions.

(*b*) *Proposal is contrary to basic U.S. tax policy*

It is a fundamental principle of all aspects of American and international law that a corporation is regarded as an entity separate from its shareholders. Thus the shareholder is not obligated by the contract of the corporation, and is not responsible for its wrongful acts. This principle has been incorporated in the Federal income tax law. A corporation is taxed on its income, and the shareholders are taxed only on dividends distributed to them. Any proposal to tax the U.S. shareholders on the income of the corporation would be an exception to this basic principle, which has been followed consistently by Congress, the Treasury Department, and the Supreme Court. The basic principle has been reflected in U.S. tax treaties and in the claims of tax jurisdiction which the United States has made in the absence of tax treaties.

Both in the domestic and foreign field, taxpayers are only subject to tax on income actually realized. Corporations and individuals owning shares of stock are not taxable because of accumulated earnings of the companies issuing the shares, nor are they taxable in respect of increases in the quoted market prices of those shares. Holders of corporate securities are not entitled to deduct, from their taxable income, any decreases in quoted market price or generally any operating losses of the companies which may dissipate their surplus or even impair their capital. The U.S. income tax system recognizes fully the corporate entity. A U.S. parent corporation is taxed upon the dollar dividend received from a foreign subsidiary, because that is the correct measure of its realized income.

The principle that income must be realized before it is taxable has frequently been upheld by the Supreme Court. In 1918, the Supreme Court drew a distinction between corporate accumulations and distributions, treating only the latter as taxable income. The Court stated: "It is evident that Congress intended to draw, and did draw, a distinction

between a stockholder's undivided share or interest in the gains and profits of a corporation, prior to the declaration of a dividend, and his participation in the dividends declared and paid; treating the latter in ordinary circumstances, as a part of his income for the purpose of the surtax, and not regarding the former as taxable income unless fraudulently accumulated for the purpose of evading the tax." (*Lynch* v. *Hornby* (247 U.S. 339 at p. 343)). The fact that income must be "realized" is clearly set forth in *Eisner* v. *Macomber* (252 U.S. 189, 40 Sup. Ct. 189 (1920)) and has never been reversed.

The Treasury Department has followed the concept that income must be realized in order to be taxable; e.g., Regulations 1.61–1 provides in part: Gross income includes income *realized* in any form. [Italic added.]

Furthermore, the treatment of a foreign corporation as an entity, distinct from its shareholders, is recognized as a fundamental principle in 21 tax treaties, affecting some 44 foreign jurisdictions, to which the United States is a party. Even in the absence of tax treaties, the United States has recognized the foreign corporation as a separate entity and has never claimed tax jurisdiction over them, because it was owned in whole or in part by U.S. shareholders.

Since the enactment of the 1913 act, the United States has claimed jurisdiction to tax on the basis of (1) citizenship and residence, and (2) source of income in the United States.

To expand this jurisdictional claim, so as to tax, directly, the income of foreign corporations, because of American ownership of shares in such corporations, would run counter to all U.S. jurisdictional claims and might well bring about conflicts with the jurisdictional claims of foreign governments. It is undesirable, if not improper, for the United States to tax foreign corporations directly on their foreign income. These same considerations should apply to taxing the foreign corporation indirectly by taxing the shareholders.

The jurisdictional claims of the United States reflect the recognition that other sovereign nations have rightful claims to the primary jurisdiction of income earned by their corporations in their home country and in all countries other than the United States. The jurisdictional concepts of the United States are formally reflected in tax treaties between the United States and foreign countries which are discussed below.

The Secretary's explanation of his proposal states that "precedent for this tax treatment may be found in the provisions of existing law dealing with U.S. shareholders of foreign personal holding companies." These provisions are not an adequate precedent for such a broad departure from established tax policy. The provisions were enacted on the assumption that foreign personal holding companies were "created with the sole purpose of avoiding or evading the imposition of the surtax on their shareholders" and the legislation was intended "to encourage the prompt dissolution of existing companies of this type," which were regarded as

"spurious" (report of the Joint Committee on Tax Evasion and Avoidance, Aug. 5, 1937, 75th Cong., 1st sess., H. Doc. 337, pp. 21 and 22). However, these provisions were never intended to, and do not, by the definition of foreign personal holding companies in the Internal Revenue Code, affect bona fide foreign business companies.

The foreign personal holding company provisions are strictly limited to the case where the foreign company is controlled by not more than five U.S. citizens or residents and derives 50 percent or more of its gross income from certain categories of income, such as dividends, interest, and capital gains (secs. 551–557, I.R.C.). The proposed recommendation by the Secretary is addressed to a situation which is quite different from that of the foreign personal holding company. With relatively few exceptions the foreign subsidiaries which will be affected are operating companies that would not be within the purview of the foreign personal holding company provisions. These foreign corporations have not been "created with the sole purpose of avoiding or evading the imposition of (a tax) on their shareholders." Rather these subsidiaries were formed to carry on U.S. trade and business in a part of the world most important from the viewpoint of national as well as business considerations. Further, it is not believed that "the prompt dissolution of existing companies of this type" is intended even by the Treasury. Therefore, it is urged that the foreign personal holding company provisions should not be regarded as precedent for the proposed legislation. An additional point which should be considered is that the foreign personal holding company provisions are primarily an extension to foreign companies of a punitive provision which previously was in effect domestically; namely, the personal holding company provisions.

The proposal to tax a shareholder on unrealized profits is, in effect, taxation by indirection of the current earnings of the foreign corporation and is designed to tax indirectly what could not be taxed directly. This policy of taxing by indirection is at least questionable from the standpoint not only of domestic tax policy but also of international comity. Probably any attempt by the United States to tax directly or indirectly foreign corporations on income not earned in the United States would be objected to by foreign countries. In the past, foreign countries have objected to the extraterritorial effect of other U.S. laws, for example, the extension of the antitrust and export control laws.

The proposals of the Secretary to impose taxes on U.S. shareholders of foreign corporations measured by the earnings of the foreign corporations as they accrue will result in a nullification of tax incentive programs designed by foreign countries to attract investment and reinvestment by foreign corporations. It would defeat the purpose of provisions under foreign tax laws, such as investment allowances, accelerated depreciation, and tax exemptions designed to promote economic development in the foreign country. It

would also ignore requirements of the foreign country that legal and statutory reserves be set aside before dividends can be paid. It would be contrary to the practice in some countries which impose through private agreement restrictions on dividend distributions.

Foreign competitors of U.S. business would still enjoy the benefit of these incentives. Where American investments are an important factor the foreign country might revise its incentives program, and attempt to bring its tax rates up as high as 52 percent in order that it may obtain taxes which otherwise would redound to the benefit of the United States.

The proposal will have an adverse effect both on the corporations and shareholders. In many instances, shareholders may not have funds available from other sources to pay the taxes. This, of course, will place pressure on the foreign corporation to remit income to pay such taxes. Where local nationals are also shareholders and have a controlling voice in the company this pressure to distribute funds which otherwise would not be distributed in order to pay U.S. tax will be resisted. From a long-range point of view, it may deter local participation in companies in which American capital is invested. Furthermore, the individual shareholder who in most instances would have no control over the foreign corportation whatsoever could receive no foreign tax credit and would be required to pay such income tax out of his capital. Many foreign incorporated subsidiaries have incurred long-term financial commitments on the reasonable assumption that neither the subsidiary nor the shareholder would be subject to U.S. tax on the undistributed income of such subsidiaries. The proposed imposition of U.S. tax on U.S. shareholders might affect drastically the ability of the subsidiary to meet the financial obligations.

The proposal to tax the U.S. shareholder of a foreign corporation on the undistributed income of such corporation is contrarty to basic tax principles which have been followed since 1913. A departure from these principles would constitute a drastic change in this fundamental area of tax policy. It would constitute a deviation from the recognition of the separate entity of the corporation without which concept it would be impossible to conduct much of modern business. It would raise serious questions in the international field. Possibly one of the most important questions that should be considered would be the precedent that enactment of such proposal might constitute for taxing U.S. shareholders on the undistributed income of U.S. corporations.

(*c*) *Constitutionality*

Under the proposal, American shareholders of foreign corporations would be taxed on their share of the income of those corporations, even though it is not distributed. It has been held to be a violation of the due process clause of the 14th amendment to the Constitution for a state to measure the tax on one person's income by the income of another. *Hoeper* v. *Tax Commission* ((1931) 284 U.S. 206). It would seem equally a violation of the due pro-

cess clause of the 5th amendment for the Federal Government to measure the proposed tax on the American shareholder by the income of another person, the foreign corporation.

Under the 16th amendment Congress may tax incomes, from whatever source derived, without apportionment. It should be noted, however, that the 16th amendment is applicable only to true income taxes and that a tax cannot be brought within the scope of that amendment merely by calling it an income tax.

Eisner v. *Macomber* ((1920) 252 U.S. 189, 206), held that income consists not in a growth or increment in value of an investment, but something of exchangeable value proceeding from the property, severed from the capital and coming into, or received by, the taxpayer, and that a stock dividend was not income within that definition because it did not accomplish an actual distribution of corporate earnings. The Court refused (p. 214) to "indulge the fiction" that the stockholders "have received and realized a share of the profits of the company which in truth they have neither received nor realized" and held that the corporation must be treated as a substantial entity separate from the stockholder. It went on to say that "enrichment through increases in value of capital investment is not income in any proper meaning of the term" and (p. 217) that to tax the shareholders upon their property interest in the stock of the corporation would be taxation of property because of ownership, and would require apportionment under article I of the Constitution. The Court expressly stated (p. 219) that "what is called the stockholder's share in the accumulated profits of the company is capital, not income." It follows from the holding in this case that the proposed tax on American shareholders of foreign corporations, measured by their shares of the undistributed income of those corporations, which they have not received as dividends, would be a direct tax on the shareholders because of ownership of shares and would not be a tax on income within the meaning of the 16th amendment. Under article I of the Constitution direct taxes must be apportioned among the States according to population. In *Pollock* v. *Farmer's Loan & Trust Co.* ((1895) 158 U.S. 601) it was held that taxes on personal property, or on the income of personal property, are direct taxes.[20]

An eminent student of taxation, Dr. Dan Throop Smith, professor of finance at the Harvard Graduate School of Business Administration and a former Assistant Secretary of the Treasury, in his appearance before the Committee on Finance on April 27, in referring to section 13 [21] of the act H.R. 10650 as passed by the House said:

Section 13, I believe, is extremely bad. It seems to be based on a misconception, in fact on several misconceptions. The attempt to extend our tax jurisdiction over the undistributed income of foreign operating subsidiaries is, I submit, unsound in principle, extremely difficult in application, and

[20] Revenue Act of 1962, hearings before the Committee on Finance, U.S. Senate, 87th Cong., 2d sess., on H.R. 10650, pt. 6, pp. 2686–2693.

[21] Sec. 13 was amended and is now sec. 11.

very much against the longrun national interest if the United States is to participate freely in the world's trade and income.[22]

Further problems involving our treaty obligations are presented in section 11. While the language technically does not violate our tax treaties, the consequences of the enactment of the legislation would definitely be contrary to the spirit and intent of these treaties and conventions. Again, the effect of these considerations was set forth by Mr. Brady, and the pertinent portions of this statement follow:

> The proposal to tax *shareholders* on the undistributed income of foreign incorporated companies which is earned outside of the United States is a principle which has no counterpart in the tax systems of the major industrialized countries of the world. An analysis by local fiscal experts of the tax systems of Australia, Belgium, Canada, Denmark, France, Germany, Italy, Japan, Netherlands, Norway, Sweden, and the United Kingdom indicates that none of them applies such a principle. In 1939 the German Government enacted a provision under which a foreign subsidiary which is dominated by a German company may be regarded as resident in Germany and taxed on all its income. Such tax would be imposed on the subsidiary and not on the shareholder. It is understood that this provision has been rarely applied in the past and that it is not anticipated that it will be enforced in the future. The United Kingdom and Japan also have in exceptional cases treated a foreign corporation as a resident for tax purposes if its mind and management are within the country, but this means that the corporation itself becomes liable for tax and not its shareholders. Under present practice the mind and management of a company will not be located in the country if the administrative office, directors' meetings and general managerial functions are conducted outside the country.
>
> The proposal attempts to expand the jurisdiction of the United States, beyond that normally considered by any other country, so as to tax the shareholder, solely by reason of his ownership on his share of the earnings of a foreign corporation before such earnings are distributed. Inasmuch as such a policy, if adopted by United States, would add a new principle in the international tax field we do not believe that the Congress will wish to attempt to expand its taxing jurisdictions to such extremes.
>
> In his appearance before the Committee on Ways and Means the Secretary of the Treasury stated in discussing the proposal to tax to the U.S. shareholder the undistributed income of foreign corporations:
>
> "This method of taxing would eliminate possible conflicts with U.S. treaty obligations, which might occur if the tax were imposed directly on the income of foreign corporations."
>
> He considers that treaty obligations would not be violated if the domestic shareholders were required to "include in gross income each year that portion of the undistributed

[22] Ibid., pp. 3088–3089.

earnings and profits of the foreign corporation which they would have included in gross income had the foreign corporation distributed its entire profits for the year." Nevertheless, the tax is levied on the basis of income that belongs to the foreign corporation and not to the shareholders.

Treaties are founded on respect by one party for the laws of the other, except insofar as the treaty limits their respective jurisdiction to avoid double taxation. They respect the principle that the corporations of the other country may conduct their affairs in accordance with the laws of the other contracting party. Treaties are founded on reciprocity and if the United States invades in effect the jurisdiction of the other party to levy a tax, even if it collects the tax from its own resident shareholders, the United States could not object if the other foreign government levied a reciprocal tax based on the undistributed income of U.S. corporations. This initiation on a wholesale basis of extraterritorial taxation of the type could seriously damage international investment and business relations conducted through subsidiaries and would certainly violate the intent, spirit and basic principles of the 21 tax treaties which are in effect vis-a-vis some 44 foreign governments.

The principle that a tax can be levied generally on the basis of a foreign corporation's income or a portion thereof, but collected from the shareholder is absolutely contrary to long-established principles of international tax treaty law as well as American jurisprudence. It has been argued that, under the treaties, the United States, in determining its taxes in the case of its citizens, residents or corporations, may regardless of any other provision of the treaties, include in the basis upon which such taxes are imposed all items of income taxable under the revenue laws of the United States as if the treaties had not come into effect. This is the so-called saving clause. However, the doctrine of *Eisner* v. *Macomber*, that the income tax is imposed on realized income, pervaded at the time of entering into the treaties and since that time in U.S. tax law. This doctrine must be considered as reflected in the meaning of the treaty provisions. The saving clause should therefore be read to refer only to items of realized income, including dividends from a corporation of the treaty country, and not to unrealized income.

Our first tax treaty was entered into with France. The primary objective of the treaty was to prevail upon France to give up its tax on dividends distributed by U.S. corporations which were deemed to be paid out of income from French sources. Because of this tax the United States adopted the provision for a retaliatory tax against discriminatory or extraterritorial taxation now found in section 891, I.R.C. The French agreed to waive their extraterritorial dividend tax in consideration of a treaty provision authorizing the French Government to collect tax from the French company on any income shown to have been diverted from it to an American corporation. However, when this convention with France and each subsequent convention

was negotiated, no other country sought to tax shareholders resident in its territory on undistributed income of a foreign corporation because of control or ownership.

It will be observed that the United States reacted sharply to an extraterritorial imposition of tax by France. In effect the Treasury proposal would tax income of foreign corporations derived from foreign sources. The treaties specifically limit the jurisdiction of the United States over a foreign corporation to income from sources within the United States, and therefore the United States is obligated not to tax the income of a foreign corporation from sources without the United States. Would it be too much to expect that foreign countries in general, and treaty countries in particular, would react sharply by similar retaliatory taxes to U.S. taxation of the income of their corporations before it is paid out in dividends?

Congress has, through the enactment of two provisions in the code, clearly expressed its policy to be against the violation of tax treaty obligations. Section 894 requires that income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from tax under this subtitle. This should include the foreign income of a foreign corporation to the extent it is not distributed to U.S. shareholders.

Section 7852(d) provides that no provision of this title shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of this title, and respect for international comity would require a similar provision be incorporated in any future tax legislation with international implications.

There is another provision in a number of tax conventions and executive agreements that would also be violated by the proposed amendment; namely, the provision for exemption from U.S. tax, on condition of reciprocity, of income derived in the United States from the operation of ships and aircraft which provides that such income shall not be included in the gross income of a foreign corporation and shall be exempt from taxation. Yet, if the foreign corportion which benefits from this exemption happened to be within a developed country or to be classified as a tax-haven corporation, the recommendation would tax the income that is thus not includible in the gross income of the foreign corportion.

The Supreme Court has declared: "The principles which should control the diplomatic relations of nations and the good faith of treaties as well, require that their obligations should be liberally construed so as to effect the apparent intention of the parties to secure equality and reciprocity between them" (*Jordan* v. *Tashiro*, 278 U.S. 123). Obviously, all our tax treaties were concluded with reference to to the United States and foreign laws in effect when the treaties were negotiated, and it was not contemplated that the United States might someday tax U.S. shareholders on

> the profits of foreign corporations before they are distributed. This, it is believed, violates the spirit and intent of tax treaties.[23]

The many amendments adopted during the course of the committee's consideration of this measure do not alter the basic principles of levying a tax on U.S. shareholders of so-called "controlled foreign corporations" based on their unremitted earnings.

The amendments adopted by the committee have lessened the impact of the added tax burden, but they do not deal with the fundamental problem of a basic change in the concepts which have guided the Congress for almost 50 years in the enactment of all tax legislation.

Should section 11 be enacted into law, retaliatory measures may be adopted in other countries. In any event, it will most probably be difficult to negotiate new tax treaties that further the commerce and interests of our Government and its citizens.

SUMMARY AND CONCLUSIONS

These views have set forth the many reasons why the objectives the administration seeks cannot be achieved through the enactment of section 11 of H.R. 10650 as reported by the Committee on Finance. The objectives are desirable, but the means that have been recommended for their accomplishment are impractical and unworkable.

The administration has long been on record that it will recommend additional basic reforms in our tax structure for the consideration of the Congress next year to become effective January 1, 1963.

Section 11 of H.R. 10650 also provides that it shall be effective with respect to the taxable years beginning after December 31, 1962. It thus appears that if section 11 were enacted into law by the 87th Congress, the Secretary of the Treasury would have only 4 months in which to establish the rules and regulations for its implementation. Of necessity rulings would conform to the present basic tax laws. If the 88th Congress enacts a broad program of tax reform, then it will be necessary for the Secretary of the Treasury to redraft completely the rules promulgated under section 11 of the pending bill to make it conform to a new tax code which also will be effective January 1, 1963. Such a procedure will entail expense and difficulties for the Internal Revenue Service to say nothing of the confusion and cost of compliance that will confront taxpayers.

It would appear that the Internal Revenue Service should concentrate on more effective enforcement of existing law rather than apply itself to the promulgation of rules and regulations which will require revision within a matter of months.

When the Congress considers the broad issues of tax reform, it should give consideration to necessary amendments to existing law to prevent evasion and simplify the burden of reporting for both the taxpayers and the Internal Revenue Service on all phases of foreign source income.

The administration's objections will not be achieved by the enactment of section 11 of the bill as reported by the Committee on Finance at this time. The testimony that has been considered by both the House Ways and Means Committee and the Committee on Finance

[23] Ibid., pp. 2694-2698.

during the 87th Congress should supply information that will be of assistance to the administration and the Congress in developing a workable program for the collection of proper taxes on foreign investments without establishing practices which may be unconstitutional, as they impose taxes on earnings that have not been constructively received by the taxpayer. The enactment of section 11 at this time can only result in years of costly litigation. Many taxpayers will not know their true tax liabilities, and the Treasury will be unable to properly estimate the tax revenues to which it is entitled until the Supreme Court has interpreted this legislation.

The only recommendation that can be made to the Senate on the basis of a careful and deliberate consideration of the entire record is to postpone action on section 11 and reconsider this entire subject in conjunction with the administration's basic tax reform program when it is presented to the 88th Congress.

Frank Carlson.
Wallace F. Bennett.
John Marshall Butler.
Carl T. Curtis.
Thruston B. Morton.

SUPPLEMENTAL AND MINORITY VIEWS OF SENATORS PAUL DOUGLAS AND ALBERT GORE

Introduction

When the administration proposed this bill a year and a half ago, it was intended to close a few of the loopholes which disgrace our tax system and cause grave injustices and irregularities in the application of our tax laws. The total amount of revenue which would have been saved to the Treasury and hence to the people was, by the terms of the President's original proposal, approximately $2.3 billion. A brief description of these reforms and the amounts expected to be realized during the first full year of their operation will be found in the first two columns of table I.

To "sweeten" the proposals for tax reform and make them more acceptable to those who had been avoiding the just payment of taxes on certain income in the past, a tax reduction was offered consisting of a generous tax credit on most forms of net business investment in depreciable property. It was estimated that on an annual basis, this would lose $1.7 billion in revenue.

The original plans of the administration thus provided for an overall annual increase in revenues of about $600 million. But it is probably fair to conclude that knowing the tendency for tax reform proposals to be whittled away and indeed to evaporate as they move through Congress, the administration really would have been satisfied if the "loophole" closing and the investment credit finally offset each other so that there would have been little or no net revenue gain or loss. The basic orginal aim of the bill was therefore (1) to effect minor and, it was believed, less controversial changes in the field of tax reform, and (2) to balance this with an approximately equal reduction in the taxes paid by business and industry. This latter was framed in such a way that it was hoped it would stimulate new investment and the modernization of machinery and equipment.

In the long-drawn-out process of nearly a year and a half during which this bill has moved slowly through the other body and through the Finance Committee, it has been disfigured almost beyond recognition.

The proposal to repeal the 1954 dividend credit of 4 percent and exclusion of $50 which would have reclaimed $450 million a year for the Treasury and the people was thrown overboard early.

The main feature on the loophole closing side, namely, the withholding at the source on dividends and interest income paid by institutions, was eliminated by a lopsided vote in our committee. It is estimated that, in itself, this would lose about $900 million in revenues from taxes which are owed but not paid. This step was taken by the committee to the accompaniment of a tornado of mail stimulated by building and loan associations, banks, and savings institutions. One

of the signers of this minority report received no less than 75,000 letters from his constituents demanding that withholding be eliminated from the bill. These letters portrayed gross misconceptions of what the withholding method really was. Thus, (1) from a third to a half of the correspondents thought that it was a new tax; of course, it was no such thing. Interest and dividends are income just as much as wages and salaries and as such are equally taxable. The fact that so many thought it would be a new tax strongly suggests that many of these people have not been paying these taxes in the past. (2) It was charged that this was a tax on capital, whereas it would only be a method to collect the tax already owed on the interest or dividend income earned. (3) The administrative difficulties as we shall see were also grossly exaggerated.

Under heavy battering from American corporations doing business abroad, the proposed levies on them based on earnings of their foreign subsidiaries were progressively softened.

On the other side of the balance sheet there was some reduction in the amounts granted for the investment credit. But the overall result is that, if the present bill is enacted, there will be a net revenue loss of at least $550 million, and, in our judgment, nearer $700 million a year.

What was originally a bill in which the revenue losses would at least be balanced by the revenue gains has now become a bill in which the revenue losses greatly exceed the revenue gains.

What was originally a bill in which a few of the most glaring and, on the whole, less controversial loopholes were to be closed has, in its present form, turned into a bill in which a few minor loopholes are closed but in which some new major loopholes and truckholes are opened.

What was originally a bill to stimulate new marginal net investment has now become a bill in which a tax favor is granted even for less investment than in the past.

What was originally a bill to close some of the most glaring loopholes with respect to business expense account deductions has now become a bill in which business groups will be given new deductions for lobbying on behalf of their own selfish interests.

In other words, in its present form, what was on balance a tax loophole closing bill has, on balance, become a tax loophole opening bill.

Unless major changes are made in this bill either on the floor of the Senate or in conference, we must vote against it.

TABLE I.—*Evolution of the Revenue Act of 1962—with pertinent revenue estimates* [1]

LOOPHOLE CLOSERS

President's proposals of Apr. 20, 1960	Revenue gain	House bill	Revenue gain	Revenue decrease compared to President's proposal	Finance Committee bill	Revenue gain	Revenue decrease compared to House bill	Revenue decrease compared to President's proposal
	Millions		*Millions*	*Millions*		*Millions*	*Millions*	*Millions*
Sec. 4. Expense accounts Provides that the cost of business entertainment, including club dues, and the maintenance of entertainment facilities (such as yachts and hunting lodges) be disallowed in full as a tax deduction. Restrictions should also be imposed on the amount to be deducted as business gifts, on travel expenses for vacations that are combined with business travel, and on excessive personal living expenses incurred on business travel away from home.	$250	Under the House bill expenditures for entertainment activities must be directly related to the active conduct of the taxpayer's trade or business and those for entertainment facilities such as yachts must meet an additional test of being primarily in furtherance of the trade or business. Deduction was denied for business gifts in excess of $25, a standard of "reasonableness" was added to the provisions dealing with traveling expenses, and a good rule requiring substantiation of expenditures was adopted.	$125	$125	The Finance Committee added to the directly related test of the House bill a liberalizing test permitting the deduction of entertainment expenditures if they are directly "associated with" the taxpayer's trade or business. In addition, the committee's report is very weak and confusing—quite unlike the report of the House Ways and Means Committee which provided some meaningful guidelines that made the House provision workable and effective.	$60	$65	$190
Sec. 6. Mutual savings banks The existing bad debt reserve formula of 12 percent of deposits, which has resulted in virtual tax exemption, would be reviewed to assure "nondiscriminatory treatment." The Treasury Department Report of July 1961 suggested alternative methods of taxation to produce revenue of between $150 to $416 million, at 1963 levels of income, depending upon alternative selected.	$150–416	Provided a bad debt reserve deduction of 3 percent of the increase in real estate mortgage loans or, alternatively, a deduction of 60 percent of retained earnings. Technical provisions changed definition of "domestic building and loan association," prevented capital stock savings and loan associations from distributing to stockholders pre-1952 tax-free surplus, removed certain exemptions from excise taxes, and applied realistic rules for computing bad debts resulting from mortgage foreclosures.	$200	----------	In the case of capital stock savings and loan associations, the special deduction of 60 percent of earnings was reduced to 50 percent to produce additional revenue of about $5 million annually. Other changes modified definition of domestic building and loan association, broadened repeal of excise tax exemptions, imposed ceilings on amount of reserves, and took into account tax-free surplus accumulated prior to 1952 to the extent necessary to place all institutions on an equal basis.	$205	+$5	----------

See footnotes at end of table.

TABLE I.—*Evolution of the Revenue Act of 1962—with pertinent revenue estimates* [1]—Continued

LOOPHOLE CLOSERS

President's proposals of Apr. 20, 1960	Revenue gain	House bill	Revenue gain	Revenue decrease compared to President's proposal	Finance Committee bill	Revenue gain	Revenue decrease compared to House bill	Revenue decrease compared to President's proposal
	Millions		*Millions*	*Millions*		*Millions*	*Millions*	*Millions*
Sec. 8. Mutual insurance companies Provided for the elimination of the special provisions of existing law which are applicable only to mutual fire and casualty insurance companies, so as to tax such companies on total income in essentially the same manner as stock fire and casualty insurance companies.	$50	Provided a modified total income approach which permits a portion of underwriting income to be set aside tax free in a special reserve for protection against losses. Also, provided special rules for concentrated risk companies, reciprocals, factory mutuals, mutual marine companies, and certain small mutuals.	$40	$10	Changed the order in which losses are to be charged to the special protection against loss reserve. Other changes liberalized the provisions of the House bill relating to concentrated risk companies, reciprocals and certain small mutuals, and provided a special rule for taxing mutual flood insurance companies.	$35	$5	$15
Sec. 13. Gain on depreciable property Gain on sale of depreciable property, both real and personal, should be treated as ordinary income to extent of prior depreciation.	$200	Removed real estate from application of provision.	$100	$100	Same as House bill.	$100	$0	$100
Sec. 17. Cooperatives Provide that all earnings of a cooperative arising from business activities are taxable to either the cooperative or its patrons. The patrons (and not the cooperative) would pay the tax on patronage distributions in money or noncash allocations meeting certain conditions. The cooperative would be taxable on earnings which are not returned to the patrons.	$35	The Ways and Means Committee made several refinements in the bill, none of which affected the revenue estimate. The primary change requires the patron to consent to paying the tax on noncash distributions before he is taxable and the cooperative receives a deduction.	$35	$0	The Senate Finance Committee made 2 changes in the House bill, none of which affects the revenue estimate. One would require the cooperative to distribute at least 20 percent of its patronage dividends in cash in order to escape tax—this replaces the 20-percent withholding that would have been required under the House bill. The other change prescribes an alternative method for a patron to consent to paying tax on noncash distributions.	$35	$0	$0
Sec. 19. Withholding Provide for withholding of 20 percent from interest, dividends, and patronage dividends.	[2] $880	The Ways and Means Committee made several important refinements in the bill, but none of them affected the revenue estimate. The most important changes were the inclusion of exemptions for nontaxable persons and the extension of the quarterly refund procedures to taxable individuals who are subject to overwithholding.	Same	----------	The Senate Finance Committee deleted the withholding plan and substituted an expanded information reporting plan under which all dividend, interest, or patronage dividend payments of $10 or more a year must be reported to the Government, with a copy of the information given to the payee.	[1] $275	[2] $605	[2] $605

FOREIGN INCOME								
Sec. 12. Controlled foreign corporations Provide for the elimination of deferral of U.S. tax of foreign subsidiaries.	$230	The House bill would eliminate deferral with respect to certain tax haven profits, earnings not reinvested in an existing business in a developed area or in an active business in a less developed area and earnings reinvested in the United States in such a way as to constitute a constructive dividend. However, tax haven profits which were invested in less developed areas would not be covered.	$85	$145	The Senate Finance Committee restricted its approach to the elimination of deferral for tax haven profits and those earnings invested in the United States. It improved the taxation of tax haven profits by (*a*) including certain service income and branch sales profits, (*b*) excluding the profits of certain active businesses from the definition of tax haven profits, and (*c*) eliminating the "pour over" of developed-area tax haven profits into less developed countries. The committee also added 2 important exceptions for (*a*) the earnings of certain export trade corporations and (*b*) the earnings of certain foreign subsidiaries or groups of foreign subsidiaries which distributed specified minimum percentages of their after-tax earnings.	$85	$0	$145
Sec. 9. Gross-up Provide for "gross-up" of dividends received by U.S. companies from their foreign subsidiaries so as to correct the inadequacy of the existing foreign tax credit fromula under which the combined U.S. and foreign tax may be substantially lower than 52 percent. Under existing law, the disparity between 52 percent and the actual combined rate varies with the actual foreign taxes paid, being highest at 26 percent and gradually diminishing as the foreign tax drops below or rises above 26 percent.	$35	With the exception of a 2-year grace period for previously accumulated earnings, the Ways and Means Committee adopted the President's recommendation.	$35	$0	The Senate Finance Committee adopted the proposal only with respect to dividends received from operations in developed areas. The existing formula would continue to apply for dividends paid from less developed country earnings.	$25	$10	$10

See footnotes at end of table.

TABLE I.—*Evolution of the Revenue Act of 1962—with pertinent revenue estimates* [1]—Continued

LOOPHOLE CLOSERS

President's proposals of Apr. 20, 1960	Revenue gain	House bill	Revenue gain	Revenue decrease compared to President's proposal	Finance Committee bill	Revenue gain	Revenue decrease compared to House bill	Revenue decrease compared to President's proposal
	Millions		*Millions*	*Millions*		*Millions*	*Millions*	*Millions*
FOREIGN INCOME—continued								
Secs. 5, 7, 10, 11, 14, 15, 16, 18, 20 and 27. All other foreign items.								
(For convenience, section references refer to section numbers in the Senate Finance Committee bill.)								
(1) Eliminate the tax-free nature of certain distributions by foreign trusts to U.S. beneficiaries (sec. 7). (2) Eliminate the exclusion of income for U.S. citizens residing in developed areas of the world and reduce it to $20,000 annually for those residing in less developed areas (sec. 11). (3) Eliminate the tax benefits now obtained by U.S. citizens through investments in foreign investment companies (sec. 14). (4) Eliminate the present exclusion of foreign real property from the gross estate of decedents subject to U.S. tax (sec 18). (5) Improve the information now required regarding U.S.-owned foreign corporations (sec. 20). [No recommendations similar to secs. 5, 10, 15, 16, or 27.]	$50	The Ways and Means Committee generally adopted the proposals regarding foreign trusts, foreign investment companies, foreign real estate and improved information requirements. As to the earned income exclusion, the committee provided that U.S. citizens residing abroad could annually exclude $20,000 for the first 3 years of foreign residence and $35,000 thereafter, without distinction between developed and less developed areas. The committee added provisions increasing the taxation of distributions in kind from foreign corporations (sec. 5), gain on the sale or exchange of stock in foreign corporations (sec. 15) and a provision regarding the relationship between the bill and existing tax treaties (sec. 27).	$[illegible]0	$20	The Senate Finance Committee, at the recommendation of the Treasury, added a provision providing for a special computation of the foreign tax credit with respect to certain interest income designed to halt certain flows of capital abroad which are induced by the existing foreign tax credit mechanism (sec. 10) and also added a provision providing for the taxation of gain from the sale of certain patents and other intangible rights to foreign subsidiaries as ordinary income where such gain would otherwise be taxable as capital gain under existing law (sec. 16).	$30	$0	$20
Repeal of dividends received credit and exclusion								
Repeal of provision excluding first $50 of dividends and allowing a credit of 4 percent on dividends in excess of $50.	$450	Not included in bill.	$0	$450	Not included in bill.	$0	$0	$450

Sec. 2. Investment credit Investment in new real and personal depreciable property having a useful life of 6 years or more qualified for a credit of 15 percent to the extent the new investment exceeded current depreciation allowances. A 6-percent credit was allowable on new investment between 50 and 100 percent of current depreciation allowances, with a minimum credit of 10 percent on the first $5,000 of new investment. The credit was not to affect the depreciable cost of the property. Residential property, property used outside the United States, and property used by public utilities (other than transportation) were ineligible. The credit deductible in any one year was limited to 30 percent of tax liability, but the excess could be carried forward for 5 years. The proposed effective date was Jan. 1, 1961.	*Billions* $1.7	The House approved the tax credit plan, but made the following changes: (1) Eliminated the "excess approach" in favor of a 7-percent flat across-the-board credit; (2) Excluded all buildings and certain other real property, but made personal property of hotels and motels eligible; (3) Permitted $50,000 of used property to qualify; (4) Eliminated any limitation on the use of the credit on the taxpayer's first $25,000 of tax liability; adopted a 25-percent limitation on the tax liability above $25,000; (5) Approved a 3-percent credit for public utilities; (6) Dropped the useful life requirement to 4 years, but scaled down the benefits of the credit for assets with lives between 4 and 8 years; (7) Moved the effective date up to Jan. 1, 1962.	*Billions* $1.395	*Millions* $305	The Senate Finance Committee modified the House bill in the following manner: (1) Required that the credit be subtracted from the taxpayer's cost of the property before permitting the taxpayer to compute his depreciation allowance. (2) Disallowed a credit upon the investment of insurance proceeds, and upon the purchase of livestock. (3) Approved a 3-year carryback of unused credits, in addition to the 5-year carryover. (4) Moved the effective date up to July 1, 1962.	*Billions* $1.340	*Millions* $55	*Millions* $360
Sec. 3. Lobbying expenditures The President did not recommend that a deduction be allowed for lobbying expenditures and the Treasury Department is opposed to the allowance of any deductions in this area.	----------	The House bill permits business taxpayers to deduct the following lobbying expenditures: the cost of appearing before and communicating with committees of Federal, State, or local legislative bodies, contacting individual legislators, transmitting legislative information between a taxpayer and an organization of which he is a member, and the portion of the dues paid by a member attributable to the carrying on of such activities by the organization.	[3]	----------	The Finance Committee expanded the House provision to cover the cost of sending lobbying material to employees and stockholders.	----------	[3]	----------

[1] All estimates in this table are those of the Treasury except for the investment credit as passed by the House and as passed by the Senate Finance Committee, and the revenue figures for reporting of dividends and interest, where the Joint Committee on Internal Revenue Taxation's figures are used.

[2] $670 million (based on 1959 data) $780 million based on 1960 data; $880 million for 1963 based on trends from previous years.

[3] No estimates available.

The Investment Credit—The Opening of Another Loophole

I

WHAT THE INVESTMENT CREDIT IS

1. The bill in its present form provides a tax credit of 7 percent on amounts invested in new tangible depreciable property, other than buildings, which is subject to a depreciation life of more than 8 years. There are certain limitations which can be briefly stated: (*a*) If the life of the property is less than 4 years, no credit will be granted; (*b*) if the life is from 4 to 6 years, only one-third of the credit (2⅓ percent) will be granted; (*c*) if the life is from 6 to 8 years, then two-thirds of the credit (4⅔ percent) will be granted. The credit for used property is limited to the first $50,000 of investment.

2. The bill also provides a 3-percent credit for regulated private utilities such as telephone and domestic telegraph, gas and electric companies.

3. The investment credit can be offset dollar for dollar against taxes owed up to $25,000 but above that amount may not reduce tax liability by more than 25 percent.

4. The Long amendment adopted by the Finance Committee slightly reduces the effect of these tax credits in later years by providing that the basis cost of the asset shall not exceed the value of the asset minus the investment credit. Thus, depreciation is limited to 93 percent of the original cost of the asset (97 percent for utilities).

The Department of Commerce estimates that the production of durable equipment in 1961 amounted to $25.5 billion. A 7-percent reduction in this would amount to $1¾ billion annually. This would be reduced in practice by the lower rate for the private utilities, the exceptions listed above, and the Long amendment.

It is probably safe to estimate the initial loss of revenue from this feature of the bill at somewhere between $1.1 billion to $1.4 billion. We personally believe it will amount to not far from $1.3 billion.

This measure is advocated by the majority as a means of stimulating industry to improve its plant and machinery, reduce its costs, and by stimulating investment to expand employment and reduce unemployment.

Here it should be noted that the tax credit originally proposed by the administration was on net additional investment, or the amount invested in industry over and above that allowed for depreciation. There would have been strong grounds for supporting such a proposal or one which would have given the credit to increases in investment over the average for a previous 3- or 5-year period. But during its consideration by the House Ways and Means Committee, this proposal was vulgarized almost beyond recognition. Instead of being a bonus for net additional investment or for increased investment, it was transformed into a credit for all investment (aside from buildings) or what may be termed gross investment. Thus, if a company invests less than the physical depreciation of its machinery and equipment, it will still get a 7-percent credit, or a 14-percent tax deduction on this gross investment. To repeat, an actual decrease in investment as compared with the years prior to July 1, 1962, will be rewarded.

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II

WOULD THE INVESTMENT CREDIT APPRECIABLY STIMULATE INVESTMENT?

In other words, by giving the rewards on average gross investment rather than on marginal net investment any possible stimulus to added investment is greatly reduced and in our judgment is very slight indeed. We are confirmed in this opinion by the results of the McGraw-Hill survey in the spring of 1962. The question asked by McGraw-Hill was as follows:

> If the administration's program of tax incentives for investment were enacted, how much would this increase your capital expenditures in 1962?

In reply to this, business as a whole indicated that it would raise its 1962 plans by only about 1 percent, or about $300 million. Nine out of every ten companies which replied stated that they would not use such a program in 1962.

Since the bonus under the proposed investment credit will amount to about $1.1 to $1.4 billion, this would mean that, out of every dollar which the Government will lose in taxes, less than 30 cents will find its way into increased investment in American industry. This is a very high price to pay for a little stimulus.

The National Industrial Conference Board made a special survey in late March and early April 1962 of the 1,000 largest manufacturing corporations in the United States to determine what effect the 7-percent investment credit would have upon their capital investment. While the influence of the credit on the plans of the companies varied somewhat from industry to industry, the results were that only 8 percent of those responding said they would revise their capital spending for the balance of 1962 if the credit were enacted by mid-1962. Seventeen percent of the reporting companies said they would increase their investments in 1963 if the credit were enacted by the end of the current session of Congress. But the prospective change in the dollar volume of capital spending in 1963 as a result of the credit would be as small as 1 percent.

As the report of the survey states:

> Overall, * * * the increase in 1963 outlays expected on account of the investment tax credit may be small in relation to its potential. In more than half of the industries covered, moreover, the imputed difference was less than 1 percent.[1]

There are already more than adequate funds available for investment on the part of corporations which they are refusing to use for this purpose. Thus the July 1962 Survey of Current Business, issued by the Department of Commerce (p. 24), shows that in 1961 American corporations had acquired $43.1 billion of corporate funds [2] but invested only $31.3 billion in equipment and inventories.[3] In this one year, therefore, they piled up nearly $12 billion in liquid assets.

[1] The Business Record, National Industrial Conference Board, August 1962, p. 19.

[2] Made up as follows (in billions of dollars): Retained profits, $7.3; depreciation, $24.8; sale of stocks, 4.5; sale of bonds, $5.1.

[3] Made up of $29.6 billion in plant and equipment and $1.8 billion in inventories.

There were also very large accumulations of liquid assets in preceding years, amounting to about $5 billion in 1960 and an equal amount in 1959.[4] If business conditions did not cause American corporations to invest these huge sums in past years, there is little prospect that the extra bonus of $1.3 billion will be translated into investment. What is more likely to happen is that the overwhelming proportion will also pass into the cash reserves and swell them still further. There would seem to be little prospect that the investment credit will have any real stimulative effect. It will increase the power and wealth of the already powerful and wealthy.

We should also realize that a very large percentage of plant and equipment now lies idle and unutilized primarily because there is not adequate demand for the goods which could be produced at the prices charged.

The McGraw-Hill index of plant utilization is now at approximately 85 percent. Even though the 15 percent which now lies idle is partially composed of a "standby" reserve or is markedly obsolete, it is still true that the percentage of plant utilized is 5 or 6 percent short of what would be used under full employment. Can it be maintained that, if good machinery and equipment is thus allowed to lie idle because of a shortage in effective demand relative to prices, a bonus on investment would stimulate a still further increase in machinery and equipment? For would not this still further increase the already high percentage of idle equipment?

In addition, it should be realized that, while the purpose of the investment credit is to stimulate economic growth and to help business to compete more effectively in foreign markets, it would in fact be given all the way across the board without regard to the quality or social need for the investment. Thus, the credit would be available for such investments as a new ski-lift at Sun Valley or in Vermont, an escalator in a department store, new farm machinery to spread fertilizer on lands which are already overproducing, Klieg lights in a burlesque house, and martini-mixing machines in a bar. Other investments of an even more questionable nature would receive the bonus.

It is hard to see how this increases our efficiency as compared with other countries or whether this serves meaningful economic growth.

The 3-percent credit which is to go to utilities would be completely wasted and is wholly unnecessary.

The rate of return of the private utilities is regulated by both State and Federal bodies. If regulation is properly carried out, then any favorable tax consequences of the credit would be offset by reductions in the rates charged to consumers.

If not properly carried out, it would be an outright gift to the private utilities, for it would merely increase their rate of return above that set by the regulatory bodies.

In addition, the 3-percent credit for utilities has nothing to do with other stated purposes of the credit, namely, to help modernize industry or to make it more competitive in world markets.

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[4] John K. Landrum seems to come to the same general conclusion, although with somewhat smaller increases in liquid funds. See his Corporate Profits and Cash Flow supplement to testimony before Joint Economic Committee, Aug. 10, 1962, p. 1.

III

WHO HAS BEEN GETTING THE TAX CUTS?

Let us also note the way in which tax benefits and reductions have been made during these last 8 years. In 1954, accelerated depreciation, with the double declining balance and the sum of the digits methods, was authorized by Congress. This amounted to an initial loss of revenue to the Government of at least $2 billion a year. This went to the industrial corporations and to the industrialists. At the same time the $50 dividend exclusion and the 4 percent credit were passed in 1954 which gave $400 million a year more to the owners of common stocks. This summer the Treasury has issued a new Bulletin F, permitting machinery and equipment to be depreciated much more rapidly. It is estimated that this will reduce business taxes by approximately $1.5 billion a year. All of these taken together come to just short of $4 billion a year.

Now we have this provision for the investment credit which will give the investors in machinery and equipment at least another $1.3 billion annually. Thus, in 8 years we have decreased the annual tax burden on industry by over $5 billion a year. This, of course, goes to the upper income groups in society who own the overwhelming proportion of the stock of American corporations.

During this period the low- and middle-income groups have received virtually nothing in the way of tax cuts. It is about time that the United States was less partial in its distribution of favors. This is true both on economic and ethical grounds.

IV

INVESTMENT CREDIT A FORM OF THE TRICKLE-DOWN THEORY

The basic way in which investment is stimulated and the economy moved forward is not by granting incentives for increased capital expenditures at a time when the existing plant and equipment is not fully used, but by increasing the demand for the products which the existing plant and equipment can produce which, in turn, will stimulate investment. In other words, the investment credit proposed is really a form of the trickle-down theory of economics which has largely been shown to be ineffective in the past. We believe instead in the theory that purchasing power should be built from the bottom up.

V

INVESTMENT CREDIT OPENS UP ANOTHER LOOPHOLE

Finally, the investment credit would open up more tax loopholes and would be quickly extended to other fields.

As nearly as possible a proper tax system should be neutral in the way it treats both income and expenditures. If we could have an absolutely just tax system it would probably make no distinctions as to the amount of tax to be paid on income or deductions for expenditures, no matter where the funds were derived or for what they were spent. It is the failure to carry out this principle which has so eroded our present tax system and which has made it so unjust.

For example, income from a wage or salary, in general, is taxed at the full rate, but income from oil, or from stock options, or from the cutting of timber, or from dividends, or from gains on the stock market, or from the sale of real property, among others, is taxed at lower rates and has special privileges not afforded to income from a wage or salary.

On the expenditure side, money spent for entertainment expenses, for business expense accounts, including yachts, club dues, and so forth, are deductible from taxable income, while the expenses of an ordinary person driving to and from work, or the payment of rent, or expenditures for the recreation or education of one's children are not deductible. These privileges for deductions and allowances go almost entirely to the strong, the powerful, and the well-to-do, and favor high income groups and unearned income as opposed to low income groups and earned income.

The main purpose of tax reform is to try to modify or to do away with some of these inequities and privileges in the tax laws.

What the investment credit does is to say that for social purposes we should give a special tax privilege for funds used to buy most kinds of depreciable property. At least as good a case can be made that society would be as wise to allow deductions for money spent for the education of children, for a future pension, or for preventive medicine rather than for capital investment.

Every legislator is pressed almost daily by some constituent or interest group to vote for a tax deduction for their particular interest. Once we start on this road it is almost impossible to stop. For this reason alone it is very unwise to give a special deduction for funds which are spent in this particular way; namely, for capital investment. It would be equally unwise to give deductions for most of these other proposals.

If the 7-percent tax credit is allowed on machinery and equipment, it will be only a short time before it will be granted on plant and buildings, and this will amount to another revenue loss of not far from $1.5 billion. Indeed, proposals to this effect have already been made. Residential construction would not be left behind for long and this would take another $1.5 billion away from our revenue. It would also be inevitable that the principle of H.R. 10 would find its way into enactment, and moneys devoted to purchasing voluntary retirement plans would be exempted from taxation. So would expenditures to educate children in college.

The final result would be that only income spent for current consumption would be taxed. This would be a kind of sales tax which would be highly regressive in nature and would weigh proportionately far more heavily upon those with lower or middle incomes than upon those with large resources. State and local taxation is already highly regressive. This is only made bearable by the fact that Federal taxation is progressive and hence introduces a kind of rough proportionality over the range of most incomes. To make Federal taxation also regressive or less progressive would in our opinion be grossly unjust. And yet that is precisely the end result toward which the opening of these loopholes would tend. We cannot acquiesce in these tendencies however well intentioned they may be.

The Deletion of Withholding on Dividends and Interest

I

GENERAL STATEMENT

By striking out of H.R. 10650 the plan for withholding tax from dividend and interest payments, this committee is, in effect, indicating that it condones the intolerable gap in the payment of taxes on dividends and interest, in many cases the result of outright and willful evasion. The Secretary of the Treasury estimates that in 1963 the gap between the dividends and interest that should be included on tax returns, and those that actually are, will exceed $3.7 billion. This will mean a revenue loss to the Government of almost $1.1 billion—$440 million of taxes owed on dividends, and $650 million of taxes owed on interest. Withholding would collect $880 million of this $1.1 billion. Withholding combined with the other collection and enforcement procedures available to the Internal Revenue Service would close nearly the entire gap. Without withholding, less than one-fourth of the gap can be closed. But even this cannot be accomplished until the Internal Revenue Service's new automatic data-processing system becomes fully operational in 1967.

Why must we forego hundreds of millions of dollars of additional revenue each year which is rightfully owed the Government? Why must the millions of honest taxpayers who conscientously report their dividends and interest continue to pay more than their fair share of taxes in order to make up the $880 million of lost revenue that could be collected through withholding.

Why must we continue to tolerate a tax system under which millions of wage earners pay their full share of taxes while many of those more fortunate individuals who have capital to invest are allowed to escape more than a billion dollars of taxes every year on their dividends and interest? Just look at the facts. As a result of the wage withholding plan, which has been in operation since 1942, only 3 percent of the taxes due on wages go unpaid. On the other hand, in 1960, more than 11 percent of the dividends that should have been reported on tax returns of individuals were not so reported. The situation is even more intolerable for interest where more than one-third (34 percent) is omitted from tax returns.[5] Who are the people who do not pay their taxes on interest and dividends? Of the nonreported dividends, according to a sample of from 6,000 to 8,000 returns, about 70 percent were received by individuals with *more* than $10,000 of income. Of

[5] The dividend and interest underreporting gaps are estimated from aggregate figures of the amounts of such payments to individuals and of the amounts reported by individuals on their tax returns. This method has also been used by the New York Stock Exchange and independent tax experts whose estimates have corresponded closely with Treasury estimates.

For dividends, the estimate is based on cash distributions to stockholders by domestic corporations, as reported in the Internal Revenue Service Statistics of Income, and adjustments are made to add foreign dividends received by individuals, and to exclude dividend payments to corporations, tax-exempt organizations, and persons not required to file tax returns and to exclude distributions which are not taxable or are capital gains. The balance presumably should appear on individual tax returns if there were complete compliance in tax reporting.

The interest underreporting gap has at times been estimated starting from the Commerce Department's estimate of interest receipts by individuals, unincorporated businesses, and nonprofit institutions. The Commerce Department's concept of personal interest income includes about $10 billion of imputed interest (largely interest assumed to be earned on bank deposits, which is not paid to individuals but is absorbed by the bank in lieu of service charges). The large adjustments involved in the Commerce Department concept cast a good deal of doubt upon such a gap estimate. In consequence, the Treasury has used a different approach, namely, estimating directly amounts of interest payments to individuals and then deducting certain relatively small amounts of interest received by sole proprietors as business income, by individuals not required to file tax returns, and by tax-exempt organizations.

the nonreported interest, only about 30 percent was received by people with less than $5,000 of income, while approximately 30 percent was received by those with incomes of more than $10,000. If a withholding system is appropriate for the lower income wage earners, to make sure they pay their taxes, then what possible excuse can there be for not applying it to help collect the taxes on dividends and interest from the many higher income individuals who escape those taxes today?

The answer that is given is that withholding would be too burdensome and that it would hurt too many people. In addition, we are told that the committee's substitute, an expanded information-reporting system, will give the Internal Revenue Service all it needs to collect most of the unpaid taxes. Neither of these propositions can be supported.

II

INFORMATION RETURNS NOT A SUBSTITUTE FOR WITHHOLDING

The Commissioner of Internal Revenue, the man who actually does the job of collecting our taxes, has carefully studied both the withholding plan and the expanded information-reporting program and has concluded that information reporting, even when coupled with the Service's new automatic data-processing system, cannot be an alternative to withholding. This is because an ADP information return system in itself will not collect one penny in taxes. All it can do is identify possible discrepancies which then must be followed up through the ordinary collection and enforcement procedures available to the Internal Revenue Service.

The figures [6] tell the story themselves:

Of the $850-million gap in the reporting of taxes on dividends and interest, withholding *alone* would recover $650 million at a cost of approximately $19 million. The remaining $200 million could be recovered in large part by the ADP system, combined with a reasonable enforcement effort for an estimated additional cost of $29 million. In other words, the entire gap could be closed through a combination of withholding and enforcement for a cost of only $48 million.

To close the entire gap without withholding would be physically impossible and economically unfeasible. It would mean contacting 12 million people for the purpose of checking discrepancies in their dividend-and-interest reporting turned up by ADP. This is three times as many people as the Service contacts today in its total enforcement program. It would cost $400 million to collect the $850 million by this method, more than eight times the cost if withholding were used.

Even if we were to collect all of the $650 million (the dollar equivalent to the results under withholding), it would cost $200 million to collect this amount, or more than 10 times what it would cost under withholding. In addition, the Internal Revenue Service's present enforcement staff, which through its activities collects about $3.5 billion annually, would almost have to be doubled to collect the additional $650 million. The resulting imbalance in enforcement effort is one that cannot be reconciled with any sound concept of tax administration.

[6] These figures are based on the 1959 revenue gap estimate of $850 million. It is estimated that this gap will rise to $1.1 billion in 1963.

To look at the matter realistically, and within the concept of a sensible and effective use of equipment and enforcement manpower, based on 1959 data, the information-reporting system adopted by the committee can be expected to recover only $200 million.

These figures, which were compiled by the Commissioner and his staff after careful study of the matter, conclusively prove that the information-reporting system adopted by this committee is not a substitute for withholding.

Even apart from its complete ineffectiveness as a tool for closing the more than $1 billion gap in the reporting of taxes on dividends and interest, the information-reporting plan adopted by the committee is at best a clumsy and burdensome substitute for the relatively simple withholding plan adopted by the House. Under withholding, a payer of dividends or interest would merely be required to deduct a flat 20 percent from its payments to persons who have not filed exemption certificates and then make one lump-sum payment to the Government each quarter. The payers will not have to make out individual withholding receipts for each recipient nor will they be required to submit any detailed records to the Government.

The burdens under the information-reporting plan will be substantial when compared to this. At the end of the year, each payer will be required to add up all the dividend or interest payments it has made to a person during the year and, if they equal or exceed $10 in the aggregate, make out an information return showing the name and address of that person and how much was paid to him during the year. Then this information must be filed with the Government and a copy given to the recipient. This means that the payer must make a reasonable effort to obtain the current address and account number for each of its depositors or stockholders. Translated into numbers, payers of dividends and interest will be required to complete and file with the Government 100 million pieces of paper each year and then distribute an additional 100 million copies to their depositors or stockholders.

The savings and loan industry has admitted that this information reporting plan will involve heavier administrative costs for them than withholding.

III

WITHHOLDING IS AN EFFICIENT AND EFFECTIVE METHOD TO CLOSE THE GAP

The withholding plan included in H.R. 10650 as passed by the House of Representatives has been grossly misrepresented and distorted by its opponents. They have fostered widespread misunderstanding of the plan and aroused baseless fears.

Basically, the plan is very simple. The institution which pays interest, dividends, or patronage dividends would be required to deduct a flat 20 percent from these payments and remit the total amount to the Government once a quarter. The plan includes several relief provisions which would insure that individuals and other taxpayers who owe little or no tax on their dividend and interest income will not be unduly harmed by withholding. These three basic objections have been made to the plan: it would hurt many people with low incomes who depend on their dividend and interest income for living

expenses; it would result in a maze of paperwork and confusion for the taxpayer; and it would impose heavy burdens on the paying institutions. We have already pointed out that withholding would be far less burdensome to the payers than the new information reporting plan. The other two objections are equally groundless.

1. Withholding would not hurt low-income individuals

There have been repeated accusations that withholding will unfairly deprive low-income people of funds which they need to meet their living expenses. This is just not true. Those with such low incomes that they do not owe any taxes could completely avoid withholding in most every case merely by filing simple exemption certificates with the paying institutions. Children under age 18 would be exempt from withholding regardless of their tax status. There can be no hardship for these people since withholding will not even apply.

It is true that there would be some people who, although they owe some tax, would be subject to overwithholding. These people, however, can obtain quarterly refunds of the overwithheld tax merely by filing a simple refund claim. Under the ordinary procedures, the refund would be paid within 3 to 4 weeks after the claim is filed. The Internal Revenue Service has developed a system whereby an individual who claims a refund for the first quarter will automatically be mailed claims for the next two quarters to insure that he does not forget to claim his refund. What is the hardship to these people? It is merely the loss of the interest that could be earned on the overwithholding for the first quarter, since the quarterly refund for the first quarter would offset the overwithholding in the next quarter and so on indefinitely.

The efficiency of these provisions in preventing hardship can best be shown by an illustration. Under the present law, which gives people over 65 a double exemption and also a tax credit on retirement income, an elderly couple (where it is claimed hardship will be most common) can have as much as $5,377 in income each year from social security and interest and yet be liable for no tax and, consequently, no withholding. Such a couple would be receiving the maximum social security benefit of $2,178 and interest income of $3,199. This amount of interest represents a savings account of about $80,000 earning interest at 4 percent.[7]

An elderly couple receiving the maximum social security benefit and $4,199, rather than $3,199, of interest would fall into the overwithholding category. The withholding each quarter would be $210—$160 more than their tax liability. Under the quarterly refund procedure, this couple would never be out of pocket more than the $160 of overwithholding for the first quarter. Even if the $160 must be withdrawn from the couple's savings account, it would mean a loss of

[7] The following is a schedule showing the tax computation for the couple in the example:

Total income	$5,377
Less social security benefits	2,178
Income subject to tax	3,199
Tax before retirement income credit (computed from optional table on the basis of 4 exemptions and the standard deduction)	92
Retirement income credit	92
Tax liability	

The example assumes that ⅔ of the social security benefits are received by the husband and ⅓ by the wife, which is typical where the husband has been the wage earner.

only $6.40 for an entire year, representing the interest on $160 if left in their savings account at 4 percent. This $6.40 loss must be analyzed in the context of the $105,000 savings account which this couple must have to earn $4,199 of interest for the year.[8] Is there hardship in this case?

When compared to wage withholding, the overwithholding involved in dividend and interest withholding is minimal. About 37 million refunds representing overwithholding on wages are made each year with little or no complaint on the part of the taxpayers. This was about 60 percent of the wage returns upon which taxes were paid. The average return for the 37 million wage refunds amounts to about $142. Even taking into account the fact that quarterly refunds will be permitted, only about one-fifth as many refunds will need to be made under dividend and interest withholding as under wage withholding. To look at it another way, 14.3 percent of the taxes collected by wage withholding must be refunded; the comparable figure for dividend and interest withholding is only 5.5 percent and most of this will be returned *quarterly*.

It is clear that hardship to low-income individuals cannot be used as an excuse for abandoning withholding. There just is no such hardship.

2. Withholding will be a simple and efficient means for an individual to pay his taxes on dividends and interest

It has been claimed that withholding will result in a maze of confusion for the American taxpayers. For the great majority of taxpayers, the only burden caused by withholding will be two additional computations on the tax return—those involved in a simple schedule. In addition to entering the amount of his dividends and interest on the return as at present, the taxpayer will, as a result of withholding, be required to divide this amount by four and then add these two amounts together to determine the amount of his dividends and interest to be reported as income and the amount of credit he is permitted for the withheld tax. This is the extent of the "maze of confusion" for the taxpayer.

For many taxpayers, withholding will actually reduce their paperwork, by eliminating the necessity for filing quarterly estimated tax returns.

Those who raise this objection completely ignore the fact that most Americans already operate under a much more complicated withholding system on their wages, with no maze of confusion. It is to ignore reality to say that they will not be able to adapt to the much simpler system for withholding on dividends and interest.

IV

WHO WILL BE HURT BY WITHHOLDING?

Withholding will definitely hurt a sizable group of individuals—those who fail to pay the taxes due on their dividend and interest income. It is only fair to the millions of taxpayers who already do

[8] It has been argued that the loss from overwithholding will really be much greater because of the compounding factor. Assuming a savings account where interest is credited quarterly, the loss of interest on the $160 over a 10-year period will only amount to $78.22 taking into account the compounding. This is an average loss of $7.82 each year, which is still minimal when compared to the $105,000 savings account involved.

this that these individuals be required to do the same. One of those who signed this report received 75,000 letters on withholding and a sampling of these letters showed that between one-third and one-half of them were from people who thought withholding represented a new tax on dividends and interest. Another large group thought withholding was a tax on capital.

V

SUMMARY

Withholding on dividends and interest is urgently needed—without it, this country will continue to forfeit billions of dollars in revenue that is rightfully owed by those individuals who are not assuming their fair share of the tax burden. Information returns and ADP are not a substitute for withholding.

Expense Accounts

One of the best known and most resented special privileges in the tax law today is the deductible expense account. President Kennedy described this tax giveaway as "a matter of national concern." The House of Representatives agreed. After long and careful consideration it passed a provision which, although falling short of the President's recommendations, would go a long way toward a fairer set of rules. It would permit deductions for entertainment more closely related to the conduct of business but would cut out deductions for many of the highly personal expenditures permitted under present law when the taxpayer can make a showing of some connection between the entertainment and the taxpayer's trade or business.

The allowance of deductions for such essentially personal entertainment has brought the integrity of the entire revenue system into disrepute. The expense account deduction has been a breeding ground for fraud and misrepresentation. It has encouraged disrespect for honest self-compliance with the tax laws among those not in a position to claim such deductions, but who have watched others satisfy their personal amusement at the taxpayers' expense.

What has the Finance Committee done with the House bill? It has simply pulled the teeth from the proposal, leaving it merely with a dangling tongue—a tongue which is certain to confuse taxpayer and Government official alike as to what it is trying to say. Certainly the vague and almost meaningless standard adopted by the committee will do very little, if anything, to change the style of operation of those who have been living high on their expense accounts at the cost of their fellow citizens.

Let us be more specific.

I

THE PROBLEM

The basic problem is whether this country can continue to afford to permit a small group of taxpayers to take tax deductions for highly personal items such as nightclub hopping, fancy yachts and swanky country clubs while the great majority of their fellow taxpayers cannot take such deductions. From a practical point of view the concern of the Nation is not only the basic unfairness of this situation (in itself

a vital consideration) but it is also the effect that this legally created unfairness has upon those who are discriminated against. It makes them resentful of the law which permits such a situation to exist and encourages them toward laxness in discharging their full tax obligations. It is quite natural to feel: "Why should I help keep that fellow on the gravy train—paying for his fancy yacht and swanky country club?" An expansion of this type of thinking could eventually destroy our tax system, the keystone of which is its voluntary character. We rely on each taxpayer to be his own tax assessor. The essential honesty of our citizens and, most important in this contex, their respect for our tax laws, has enabled this system of voluntary self-assessment to function most effectively. However, like all good things, the system must be nurtured and protected.

Expense account abuses have become a real threat to the continued effectiveness of our self-assessing system. Much taxpayer distaste has already been voiced against this unwarranted privilege. The danger signals are loud and clear. In his testimony before the House Ways and Means Committee and the Senate Finance Committee, the Secretary of the Treasury documented the situation in great detail with numerous case studies and many samples of editorial comment from all over the country. Let's examine a few of these.

A corporation engaged in manufacturing was allowed to deduct $991,665 in 1959 for yachts, club dues, shipboard conventions, hunting and fishing trips and parties.

A taxpayer engaged in the insurance business was allowed to deduct $97,500 for meals, lodging, transportation, entertainment, tickets, books, gifts, et cetera. The amount covered $6,000 for an apartment and over $30,000 for food, beverage, and other entertainment.

A manufacturer was allowed to deduct over $34,000 spent on liquor, football tickets, parties, and a speedboat, The expenses for liquor alone totaled $13,750.

A family-held ship repair corporation was allowed to deduct $23,758 for a Christmas dinner and party.

An enterprising banker effectively combined sentiment with business when he deducted, as present law permitted, a substantial part of the cost of his debutante daughter's coming-out party on the ground that some of the guests had business connections with him.

In another case, the taxpayer was allowed $115,000 for entertainment and gifts. His expenses included $7,500 spent at a resort hotel; $5,400 for food, liquor, and cigars for his office and farm; and $8,700 in cash to officers of his closely held corporation for entertainment.

A beverage manufacturer claimed and was allowed $10,903 for entertaining customers at the Kentucky Derby.

Huge sums are allowed to business taxpayers in connection with maintenance and operation of yachts and other fancy boats. One manufacturer was allowed to deduct $253,000 for the expense of his yacht. Another was permitted to deduct $112,000 for such expenses (as well as an additional amount of $362,000 for a ranch-hunting lodge, nightclub, and other similar expenses). A company in the business of selling fuel was allowed $93,000 as deductions for a yacht, a fuel products company was allowed $23,000 and an auto dealer was allowed yacht expenses of $22,000.

A cake and cookie bakery was allowed $66,000 for a yacht on which to entertain supermarket and chainstore buyers and branch managers.

Despite its rather sad undercurrents, both from the viewpoint of the tax system as well as otherwise, one of the most interesting cases is that in which a mortuary business was allowed $26,495 for yacht expenses to entertain visiting morticians, clergymen, and for meetings of employees.

These cases could be multiplied by the thousands. Similar large expenditures are constantly being made on hunting and fishing lodges, on elaborate beach resort homes, on exotic island retreats, on extended hunting trips, including plush safaris to far off Africa and India. Indeed, just about every kind of human activity in the nature of fun and frolic is being well subsidized on behalf of a privileged few by the average taxpayer who does not happen to be engaged in a trade or business so as to enable him to join in this Government-supported high life. Is it any wonder, then, that such strong taxpayer resentment has developed against the expense account privilege. Clarence Randall, former chairman of the board of one of America's largest steel companies has vividly expressed this taxpayer resentment in the following words:

> Gone are the days when a salesman occasionally wined and dined his favorite customer, or perhaps gave a small theater party. Nowadays, when the deal gets big enough, the company yacht weighs anchor and moves into position, the company plane takes off for a duckblind in Arkansas, or the best hotel in Miami throws open its doors to expectant dealers for a week of continuous circus.
>
> The distaff side is cut in, too, on both sides of the deal. How the ladies love it. With jet travel what it is, those who were getting a little tired of White Sulphur may now hope to look in on Capri or the Riviera.
>
> The unseen partner in all this largesse, of course, the man who rides the afterdeck of the company yacht, copilots the duck hunters' plane, sits by while the caviar is spooned out and the crepes suzettes are sizzling, the man who splits the check at the nightspot and hands the big bill to the headwaiter, is none other than Uncle Sam. * * *
>
> But who are the silent underwriters of this frenetic spending? You and I, the general taxpayers. It is we who make up to the U.S. Treasury the revenue lost through expense-account deductions.

The important point to be derived from the foregoing is that all of the expenditures described were deductible under the broad standard of present law which permits the deduction of "all the ordinary and necessary business expenses" of the taxpayer. The fact that there is a business relationship, actual or even only hoped for, between the parties does not prevent them from enjoying the fancy resort living, the cruise on the expensive yacht, or the fancy nightclub.

Suppose company A sells its product to company B. If a sales executive of company A invites his close friend, an executive of company B, to join him for a cruise on his yacht, who can say that the executive of A did not intend to promote the business relationship between the two companies? The fact is that in the usual case the businessman's friends are his business customers or prospects. Under

the test of present law, so long as this business connection exists between entertainer and entertained, the parties can enjoy tax deductible vacations in Bermuda, cruises on yachts and evenings in luxury nightclubs on a tax deductible basis. This can be done on a reciprocal arrangement of "you entertain me and I'll entertain you," with the Treasury paying half the bill for each. Business does not have to be discussed nor need the entertainment follow or precede business discussion. The taxpayer need not even be present at the entertainment. Because of absence of restrictions, taxpayers are encouraged to ask "Why should not I deduct my personal pleasures and entertainment, if everyone else can?" Because of this the expense account problem has grown to its present unmanageable proportions.

II

HOUSE SOLUTION TO THE PROBLEM

The test adopted by the House of Representatives is that the expense of an entertainment activity will not be deductible unless "directly related to the active conduct of the taxpayer's trade or business." Where an expense connected with a facility such as a yacht or a hunting lodge is involved, the taxpayer must also show that the facility "was used primarily for the furtherance of the taxpayer's trade or business." On its face, this standard seems almost as broad as present law and would appear to present many of the same problems.

However, in its report the House Ways and Means Committee has explained its test in a way which provides a number of tangible, practical, and meaningful guidelines: The report states that under its test the taxpayer—

> * * * will have to show more than a general expectation of deriving some income at some indefinite future time from the making of the entertainment-type expenditure; however, he will not be required to show that income actually resulted from each and every expenditure for which a deduction is claimed.
>
> If the expenditure is for entertainment which occurs under circumstances where there is little or no possibility of conducting business affairs or carrying on negotiations or discussions relating thereto, the expenditure will generally be considered not to have been directly related to the active conduct of business. Thus, the absence of the taxpayer or his representative from the entertainment activity ordinarily indicates that the entertainment was not directly related to the conduct of the taxpayer's trade or business. Similarly, if the group of persons entertained is large or the distractions substantial, the cost of the entertainment will not be deductible, in the absence of a clear showing of a direct relationship to the active conduct of the trade or business.

This clear statement of legislative intent coupled with the statutory language provides a workable and reasonable solution to the difficult expense account problem and should go a long way toward reducing the abuses outlined above. However, critics of the House proposal attacked this crucial committee report statement on the ground that it had no support in the statute.

In view of the broad language of the statute, requiring explanatory implementation to make it useful, this contention is baseless. The true reason for the complaint is the fact that the statute as interpreted by the Ways and Means Committee report has some real teeth in it.

Even so, we are not asking that the business community adopt Spartan standards. The House bill, which we hope will be restored, recognized the general custom of business entertaining at meals in restaurants. It specifically permits the deduction of entertainment presently allowable through furnishing food and drink in restaurants and hotels in an atmosphere conducive to business discussion. No business need be discussed. It thus leaves undisturbed the most significant portion of goodwill entertainment conducted in this country. It strikes only at the high, wide, and fancy living and indulgence in personal pleasures which all taxpayers ought to pay for themselves without Government subsidy.

III

FINANCE COMMITTEE SOLUTION—FORMULA FOR CONFUSION

The only change in the pertinent House statutory language made by the Finance Committee is the addition of the words "or associated with." Thus, a taxpayer can deduct an entertainment expenditure which is only "associated" with the active conduct of his trade or business, as well as one which is directly related thereto. Since this statutory language is quite similar to that of the House bill one would reasonably expect again to find a helpful explanation as to what the committee intended to accomplish by its additional phrase "or associated with."

Unfortunately, such is not the case. Unlike the clear, concise, and workable guidelines set forth in the House report the Finance Committee report is a mass of vague, disconnected statements and examples which are destined to spawn controversies more numerous and intense than those which occur with such disturbing frequency under present law.

Although the Senate report attempts to paint a picture of virtue and righteousness, even a casual glance beneath the surface reveals that the virtuous exterior is more illusion than reality. For example, the report states:

> * * * Nothing in your committee's bill is to be construed as allowing a deduction for any expense which is against public policy or which violates the public conscience. Deducting an expense incurred for such purpose under the guise of generating "business goodwill" will not be condoned and under your committee's amendment is not deductible. Thus, the cost of liquor purchased for the entertainment of customers and the promotion of goodwill (which under existing law has been held deductible) will be disallowed if the serving of liquor violates the public morals of the community as expressed in local law. Another example of expenses for immoral purposes which have been claimed on tax returns under existing law involves expenditures to provide "call girls" for the purpose of entertaining clients. Under your

> committee's amendment no deduction whatsoever is to be allowed for expenditures of this nature. In no legitimate sense are they "directly related to or associated with the active conduct" of a trade or business.

The foregoing suggests that the committee's action will serve as a moral broom to disallow expenditures where liquor is illegal under local law, and where "call girls" are utilized as "business" entertainment. However, expenditures such as these, which violate clearly defined lines of public policy, are not deductible under present law. See *Smith*, 33 T.C. 861 (1960); *R. E. L. Finley*, 27 T.C. 406 (1956); *U.S.* v. *Winters*, 261 F. 2d 675 (1958). What then will be accomplished under the committee's language? Is it not clear that this is simply a smokescreen thrown up to suggest that abuses are being remedied whereas in actuality little, if anything, is being accomplished beyond present law?

The Finance Committee report stresses the desirability and wholesomeness of "goodwill" entertainment. It states:

> Goodwill has long been recognized as a legitimate objective of business entertaining and where the purpose of the expense and its clear relation to a business is firmly established, *the expense ordinarily will continue to be deductible.* [Emphasis added.]

The report further states:

> To eliminate the harshness resulting from the House report, amendment of the language of the House bill is necessary. * * * This new language will permit deduction of expenses for entertainment, amusement, or recreation incurred for the creation or maintenance of business goodwill without regard to whether a particular exception applies. However, this new language will apply only if the taxpayer demonstrates a clear business purpose and shows a reasonable expectation of deriving some income or other benefit to his business as a result of the expenditure. If he meets this test, the expenditure will be considered to be associated with the active conduct of his trade or business; otherwise, the expense will be disallowed under your committee's amendment.

A close analysis of these statements makes it eminently clear that expenditures for goodwill have been given preferred status. In these references to "goodwill," the committee has presented our sophisticated expense account society with a blueprint for continued high living at Government expense. These statements constitute a formula which will leave the Internal Revenue Service with an impossible enforcement task, for, in effect, almost all entertainment expenditures, both for the creation and maintenance of business goodwill are declared to be henceforth deductible. In stating that the taxpayer must demonstrate a clear business purpose and show a reasonable expectation of deriving some income or other benefit to his business from the making of the entertainment expenditure, the committee report has added nothing to the requirements of present law. The taxpayer must meet precisely the same test today, but, as hundreds of cases illustrate, such vague and generalized requirements at present are so easy to meet as to be practically meaningless.

Furthermore, although the committee report makes numerous references to goodwill, it gives no indication as to what is encompassed by this term. Nowhere is goodwill defined. How does a businessman go about creating goodwill—whatever goodwill is? It seems clear that the sky is the limit. If a businessman—in his judgment—thinks a big yacht may be helpful in developing some customers, doesn't this committee report language put the official congressional stamp of approval on his deduction of these substantial costs of maintaining and operating such a "business" asset? Is not a revenue agent foreclosed from effectively examining into the matter?

In the light of all the foregoing statements respecting good will, very little is salvaged from the following comment—particularly in view of the illustration given as to what is meant by "vague goodwill."

> Where good will generated by the expense is vague or where the possibility of the expenditure resulting in the production of income is remote, no deduction will be permitted. For instance, under present law a taxpayer may deduct expenses of entertaining buyers and others associated with his trade or business even though at the time he does the entertaining he already has more business than he can handle. Under you committee's amendment, however, no deduction will be allowed because, with a large backlog of unfilled orders, such entertainment ordinarily cannot be regarded as being associatedwith efforts to produce income.

This narrow "exception" to the basic theme of the Finance Committee report that all good-will entertainment is deductible is scant evidence of tightening up present law. Rare indeed is the case where the taxpayer has such a backlog of unfilled orders that his entertainment activities cannot be regarded as being associated with efforts to produce income. It is interesting to note that even in such an extreme case the report hedges the consequences by providing that "ordinarily" the deduction will not be allowed. Moreover, there is a good possibility that entertainment expenditures in such a unique case are not deductible under present law because they are in the nature of capital expenditures. Cf. *James Schulz* (16 T.C. 401). Here again the committee has done nothing more than set up a strawman—to give the illusion that a cutback on existing law is being effected. In reality nothing has been accomplished—except that perhaps another arena for conflict has been created.

The "harshness" of which the report speaks is that the House provision, as explained by the Ways and Means Committee's report, has some effect and will disallow some entertainment expenditures which are deductible under present law. Presumably that is the purpose of this legislation. However, one must struggle hard to tell which of the above-described cases would be denied deduction under the Finance Committee report. How much, if anything, would be disallowed to the corporation which spent and deducted almost $1 million in 1 year for yachts, club dues, shipboard conventions, hunting and fishing trips, and parties? Does not a corporation make such expenditures to develop good will? We have already seen that good-will expenditures are clearly deductible under the Finance Committee report. How about the banker who deducted a substantial part of the cost of his

daughter's coming-out party as a business expense? Wasn't he also developing customer good will? Certainly the Government is not, under the Finance Committee report, free to disallow expenses regardless of the form of entertainment the taxpayer may adopt to develop good will. Similarly, in all the other cases set forth above, the taxpayer would appear to be able to continue to deduct all entertainment expenditures.

Under the Finance Committee report, do yachting expenses continue to de deductible? If not, then the report should clearly so state. Does the cost of maintaining hunting lodges for entertainment continue to be deductible? If not, then the committee report should so state. Is the cost of wining and dining at nightclubs deductible? If not, the committee report should clarify the situation. Do tickets at $30 apiece for musical comedies continue to be deductible? If not, the committee report should so indicate or provide some standard or guideline by which the answers to these questions can be determined by the taxpayers and revenue agents who will be left floundering in their attempts to know what the rules are.

One further "red herring" in the Finance Committee report should be mentioned. The report states that no deduction will be allowed for entertainment expenses "which under the circumstances in which they are incurred are lavish or extravagant." Here again no standards or guidelines are furnished. What is lavish or extravagant under the circumstances? If the circumstances involve a taxpayer accustomed to entertaining in an elaborate and expensive style, can they be held to be "lavish" under the circumstances? When does a yacht become an extravagant expenditure? When it is 60 feet in length? 100 feet in length? Would these criteria vary with the income (or expected income) of the taxpayer? Would a resident of Miami Beach, Fla., be entitled to a bigger and more expensive yacht than a resident of Providence, R.I.? Would a beach home with eight rooms be a lavish facility? What about one with 30 rooms? Would a corporate president be entitled to drink champagne whereas a vice president could have only a whisky highball and a proprietor of a country grocery store only ordinary corn liquor?

Is it not abundantly clear that the so-called "test" produced by the Finance Committee, superimposed upon the unsatisfactory test of present law, will simply compound existing difficulties? The litigation and controversy which would follow adoption of such meaningless language would even make the present situation seem a happy one. The result would be a real mess. And to what avail? In this posture of things, it seems quite proper to ask—what is wrong with the proposal adopted by the House of Representatives? It is obviously far superior to the Finance Committee's product. We urge the Senate to approve the House provision or the President's original proposal and again, as it did in 1960, produce a really significant legislative measure to deal with expense account abuses.

The Deduction for Certain Lobbying Expenses of Taxpayers With Business Income

Section 3 would permit the deduction of certain lobbying expenses by taxpayers with business income. This would depart from a salutary principle which has been part of the income tax law since World

War I. It would provide unwarranted tax reduction where it is least needed for reasons which are specious. It would introduce novel distinctions into the tax law, producing new requirements difficult for the Internal Revenue Service to administer. The specific language in which the deduction is cast contains ambiguities which will create continuing uncertainty as to its exact meaning, and, most important, the relationship of this provision to the whole process by which our citizens seek to influence the enactment of legislation at all levels of government was not adequately considered. Section 3 should be deleted from the bill.

Under existing law the costs of efforts to influence legislation are not deductible, a rule applicable to *all* taxpayers. Whatever the motive for a citizen's efforts to influence legislation, he now bears the whole cost of that effort himself. No part of the expense can be passed on to the Federal Government through an income tax deduction. In the constant competition for legislative favor and results at National, State, and local levels, the Federal Treasury stands neutral—and properly so.

Section 3 would change all that. It would amend section 162 of the Internal Revenue Code of 1954, the section creating the general authority for deduction of the ordinary and necessary expenses of business operation. Section 3 would add a new subsection specifically authorizing deduction of lobbying expenses in certain categories by taxpayers with business income. Only those taxpayers with business income would receive any benefit. All others would still be subject to the existing rule of no tax benefits for lobbying, a result which follows necessarily from incorporation of the amendment in section 162 and one which is specifically spelled out by the House committee report.

Some specific typical examples will bring this into sharper focus. Suppose a measure is being considered, as many have been, involving a proposed change in the standards or testing procedures for food, drugs, or cosmetics. The costs of presenting the views of drug manufacturers and distributors would be deductible. The cost of presentations on behalf of consumers or of disinterested professional or technical advisers would not be. Or suppose that a State legislature is debating a measure designed to decrease stream pollution. Manufacturers who would be adversely affected by its enactment could deduct the cost of opposition. Members of the public interested in pure water for drinking or for recreational uses would have to finance their support of the measure entirely from their own pockets. Or, at the local level, a business owner of a piece of real estate could seek advantageous amendment of the local zoning ordinance, deducting the cost of his presentation before the local city council. The owners of nearby residences would not receive this help from the Federal Treasury in preparing the exhibits and briefs necessary for effective opposition.

These are discriminations impossible to justify. Can anyone seriously contend that consideration of legislative proposals affecting business taxpayers is seriously handicapped by absence or weakness of expression of business viewpoints? Is there any evidence that business taxpayers, individually or collectively, are now deterred from expressing themselves on these subjects by the present rule of tax neutrality which permits no deduction for lobbying expenses? To

ask these questions is to answer them. Of all viewpoints on legislative proposals, those of business are consistently the most ably represented before the Congress and before State and local legislative bodies. Why then should the cost of lobbying activities of taxpayers with business income be singled out for this preferential tax reduction? No adequate reason has been given.

Any discrimination at all among citizens in the exercise of their constitutional right to petition their representatives is patently undesirable. Discrimination by preferential tax deduction is magnified as the amounts spent for these purposes increase. Modern efforts to influence legislation cover a wide range of techniques, some of which are very costly. One can send a letter to his Senator for 4 cents. However, to stimulate tens of thousands to do so requires the expenditure of large amounts running sometimes into the hundreds of thousands, even millions, of dollars. But all this is well known. It has been thoroughly documented many times.

The application of section 3 would not be confined to nominal amounts. It would permit the deduction of some very large sums. In addition to provision for deduction of the costs involved in direct contacts with legislators (personal calls and visits, appearances before committees or statements filed with them), the cost of efforts to influence legislation indirectly are also made deductible in some instances. The costs of communications to organization members and to shareholders and employees have all been blanketed in.

When section 3 is applied to today's scene, we find that it will authorize giant corporations to deduct the cost of communicating the views of management officials to hundreds of thousands, even millions, of shareholders and employees, for the purpose of influencing them with respect to current controversial legislative proposals. To use a painfully familiar example, section 3 would authorize deduction of the cost of campaigns designed to produce a flood of letters opposing withholding on dividend income.

Under existing law these sums are not properly deductible—and never have been. To permit deduction now would shift a very large proportion of these heavy costs to the Federal Treasury, a disguised subsidy for which there would be no justification.

The effects of such subsidized efforts to influence legislation indirectly would not be confined to the recipient members, shareholders, and employees. The views expressed and their source would frequently come to the attention of families and friends of the recipients, thereby broadening the scope of the influence subsidized by the Federal Treasury. Of course, the benefits of section 3 as they would apply to these broadcast efforts to influence legislation can only benefit very large organizations. Small business taxpayers, as well as nonbusiness taxpayers, would have little or no use for it and could well suffer from its use where their interests on legislative matters are opposed to those who could take advantage of it.

True, not all lobbying costs of business taxpayers would be made deductible by section 3. The bill purports to create limitations which will restrict the kind of expenses for which a deduction can be claimed. Thus, to qualify for the deduction, the legislative proposal must be of "direct interest" to the taxpayer. In addition, specific provisions deny deductions for political campaign expenses or for efforts "to influence the general public, or segments thereof." How-

ever, a close inspection raises genuine doubt as to the precise meaning and application of these restrictions. They may, in fact, prove largely illusory.

Thus, one might ask, What subjects are not of "direct interest" to a large corporation? Any measure involving a tax or a change in the regulation of business or the marketing of securities or foreign trade or the terms of employment or labor relations or the monetary system will have some impact on every substantial business enterprise. Is it intended that the cost of testimony or statements or communications to shareholders or employees on this entire range of subjects is to be deductible? Similarly, can the prohibition against deductions for political campaign purposes be really effective? Granted that the cost of a folder urging shareholders to vote for Jim Darkwater will not be deductible, what of the cost of a folder urging a position on the principal issue dividing Darkwater from his opponent Bob Cleanriver? Can issues and the candidates be separated so easily? It is doubtful. Section 3 thus could make slightly veiled political contributions deductible. The benefit would not be universal though. To return for a moment to the anti-water-pollution measure used as an example before, suppose Darkwater is against it and Cleanriver is for it. The former's supporters could deduct the cost of their literature discussing the antipollution measure (and thus their support of Darkwater); supporters of Cleanriver could not.

Obviously, congressional memories are very short. For at least a century Senators and Representatives have regularly inveighed, individually and collectively, against lobbyists and their activities. The need for substantial disclosure by lobbyists, particularly in financial respects, has long been recognized. When a person or organization becomes a lobbyist, he is required to register as such and thereafter to report quarterly his expenditures for these purposes. In spite of these safeguards, every few years some lobbyists become so bold and their overreaching so bad that a special inquiry is required. A prime example was the creation in the 84th Congress of the Senate Special Committee To Investigate Political Activities, Lobbying, and Campaign Contributions. Its report states graphically the kinds of abuses which occur and the large sums of money available to be spent on efforts to influence legislation. Sugar quota bills attract lobbyists like flies and, like flies, their activities are not widely admired. The Senate Foreign Relations Committee is currently beginning an investigation of another group of lobbyists, an inquiry which has grown in large part out of concern for their lucrative financial arrangements. Nor are problems with lobbyists confined to Washington. Their influence on State legislators and their sometimes questionable methods in State capitols is notorious.

When projected against all this experience, section 3's proposed financial bonanza for one group of lobbyists and their employers seems ironic in the extreme, if not downright cynical.

There is no challenge here to lobbying per se. It is unquestionably legitimate. A constitutionally protected right of our citizens, it often supplies useful information and reactions on pending legislation. However, it would be foolish to exalt it unduly for these reasons. At best, lobbying is a mixed blessing for it is almost always exclusively concerned with self-interest rather than the broad public interest. Fortunately, section 3 presents only a narrow problem, viz., whether

or not the lobbying done by one segment of our society—taxpayers with business income—should be entitled to support from the Federal Treasury.

A number of arguments are made in favor of this measure. Some of them have a surface plausibility, but on close analysis none of them holds water. The issue is actually a simple one. We begin with a longstanding rule that all taxpayers, business and nonbusiness, who seek to influence the work of legislative bodies, National, State, or local, pay their own expenses in full without assistance from the Federal tax system. This neutral posture of the tax law is a healthy one and should be defended and strengthened. Legislation affects all our citizens. It is entirely suitable that all who seek to influence that legislation, directly or indirectly, should be treated alike. The expenses of all should be on the same footing as far as the Treasury of the United States is concerned. The only issue here is whether or not to depart from this principle of neutrality and equality. Plainly, the case for such a change has not been and cannot be proved.

Foreign Operations

I

General Statement

Except for withholding on dividend and interest income, which was defeated outright, no major aspect of the President's recommendations for tax reform contained in his message to the Congress on April 20, 1961, suffered so badly at the hands of the Finance Committee as did those recommendations relating to the taxation of income and profits earned abroad by U.S. persons.

President Kennedy recommended that American corporations, as well as individual U.S. taxpayers who are "shareholders of closely held" foreign corporations, be taxed each year "on their current share of the undistributed profits" of foreign corporations in which they hold stock and which are "organized in economically advanced countries." At the same time, the President recommended "elimination of the tax haven device anywhere in the world."

The Ways and Means Committee and the House of Representatives moved resolutely, if not altogether perfectly, in the direction indicated by the President.

The Finance Committee, on the other hand, in executive session, by rollcall vote, refused even to consider the President's major recommendations in this area. Instead, the committee proceeded to adopt a watered down tax haven approach to this problem, and then, amendment by amendment, moved further to weaken even that wholly inadequate approach—this, despite the fact that the Secretary of the Treasury had agreed, in testimony before the committee, that anything short of removal of the deferral privilege, whereby U.S. taxation of profits earned abroad may be indefinitely postponed, would be but "piddling" with the problem.

Though the committee has done a fairly creditable job in reviewing and acting on many provisions in the foreign area contained in the House-passed bill, it has materially weakened the grossup provision, section 9, and section 11, which deals with earned income from sources

outside the United States. These provisions badly need strengthening. By far the most important provisions, however, are contained in section 12 dealing with controlled foreign corporations. It is here the Senate must surely act if this bill is to come even close to implementing the President's recommendations.

II

TAXATION AND CAPITAL FLOWS

One of the most startling economic phenomena of the past 5 years is the large-scale movement of American capital abroad. Though some of the economic activity represented by this movement may be desirable and may serve to increase exports, much of it directly and materially weakens the base of our economy. Some of this capital is drawn abroad for legitimate economic reasons. Much of it, far too much, is stimulated to move abroad because of faulty United States tax provisions.

Several reasons exist, of course, for this unprecendented movement of capital abroad. International barriers of all sorts are being broken down. Convertibility of currency exists in large measure. Electronic communications insure effective control of economic activities anywhere in the world from one central office. The movement of persons and goods has been speeded up and cheapened to a point where distance makes very little difference. American economic style and business organization have made American know-how welcome in most countries. American free world leadership has lent prestige to all things American.

In view of these facts—facts which we may not want to alter, even if we could—it is most inappropriate to set up additional artificial stimuli to the movement of American capital abroad, particularly into activities and in amounts which are contrary to the national interest. Existing law relating to the taxation of economic activities carried out by American interests in foreign countries constitutes just such an artificial stimulus to the movement of capital abroad into areas and activities which pose dangers to the domestic economy and make more difficult a solution of the balance-of-payments problem.

As our tax laws now stand, they constitute a positive subsidy to the movement of American capital abroad. There are numerous ways in which the taxation of profits from foreign operations can be reduced to the extent that it may be more profitable to expend American capital and American know-how in building up the economy of West Germany rather than the economy of West Virginia, or south Italy rather than South Carolina.

The existence of this unhappy circumstance is given implicit verification by virtue of the fact that this bill, in 11 of its 27 sections, deals with the taxation of foreign operations of U.S. taxpayers, both individual and corporate. Unfortunately, having recognized the existence of certain problems, the bill proceeds toward correction of these problems in a most timid and half-hearted manner.

Our tax laws regarding foreign operations are hopelessly out of date. For the most part they stem from rules laid down when the income tax was developed prior to the First World War. Develop-

ments in communications, transportation, and even in international politics and political organization have made some of these laws obsolete.

In theory, the United States taxes its citizens wherever they are and from whatever source their income is derived. Although this would seem to preclude the use of the tax laws as a subsidy to draw economic activity abroad, in practice we have nullified theory to a great extent by, first, allowing American interests to operate abroad in subsidiary form without the imposition of any U.S. taxation whatsoever on the profits from those operations until those profits are remitted—often in a form which can take a capital gains rate or no rate at all—and, second, by providing for a credit for foreign income taxes paid against ultimate U.S. taxes on income earned abroad.

It is now well past the time when we should have examined our basic concepts and tax laws in the light of current political and economic realities. It is well past the time when we should have given serious consideration to the need for continuing, through domestic tax law, the subsidization of the strengthening of the economies of the countries of Western Europe, Japan, Canada, and other countries which are, at least for the moment, our political allies and friends, but which are now, and in the foreseeable future will continue to be, our fierce economic competitors.

In reexamining our tax laws relating to foreign economic activities, there are three considerations which must, in the light of today's conditions, be kept in mind. These are (1) equity, always important to any tax system but doubly so in a voluntary system such as ours, (2) domestic economic health, particularly in these times of persistently high unemployment, and (3) the balance of payments.

III

TAX EQUITY

Equity in taxation is a subject to which lipservice is paid from time to time. Everyone claims to be in favor of equity, but many define equity in strange and tortured ways. Generally speaking, if a dollar earned by a particular type of taxpayer in any economic activity, in any geographical area, pays the same tax as another dollar earned under other circumstances by similar types of taxpayers we can say that tax equity has been achieved.

Of course, from time to time preferences are given to certain types of operations, certain areas, and certain organizations, but when this is done it should be done consciously, and deliberately, in the full knowledge of what is being done, and with the accomplishment of definite objectives in mind. When a subsidy is voted—and a subsidy can be awarded a taxpayer by giving him a tax preference just as surely as it can be awarded by way of a cash payment—it should be voted to accomplish a proper national or social goal, not done accidentally, or as a private giveaway.

For example, there is no question that the average homeowner receives better tax treatment than the average renter of living quarters. But the Congress has deliberately provided this because it is considered socially desirable to foster homeownership.

In certain other instances tax advantages are given inadvertently, or because of reasons which are no longer valid. Certain of our laws dealing with the taxation of the profits and income earned abroad by American taxpayers, both corporate and individual, directly and through technically foreign subsidiaries, fall in each of these two categories.

Business decisions today are often made on the basis of tax consequences. Many decisions as to what operations should be moved abroad are made on the basis of tax consequences. Many foreign operations are set up in order to avoid taxes, in a virtual maze of interlocking and overlapping organizations, confusing to customers and operators alike. This is hardly in keeping with concepts of equity or even good business management.

The best way to achieve tax equity, particularly in this field, is to seek tax neutrality, that is, to seek to have tax laws such that economic decisions are made on the basis of economic criteria, not on tax consequences. Unfortunately, the bill reported by the Finance Committee, although it recognizes the existence of inequity, does little to deal with it effectively. Under terms of this bill, operations carried on abroad will still receive favored tax treatment as compared with the same type of operation carried on here at home.

IV

DOMESTIC ECONOMIC HEALTH

It has been clearly recognized by government at all levels—Federal, State, and local—as well as by foreign governments, that taxation and tax differentials influence economic decisions. For that reason, we have seen some of our State and local government units offer various types of tax concessions when negotiating with industries to relocate. Some foreign governments have made concessions, including allowing new concerns to operate tax free for a specified number of years. The results of this type of stimulus can be clearly seen in Puerto Rico.

When the United States arbitrarily and unilaterally gives tax concessions to domestic industry, provided that industry will move abroad, the results are certainly foreseeable—and we are seeing them now. The end result is the weakening of our economy. But for some reason, many seem to feel that loss of capital and productive facilities is good for the United States, although bad for other countries.

The tax stimulus to the movement of productive facilities abroad is a subject which has been widely discussed for some years. For example, a study made by the American Management Association in 1960, and reported in Business Week for December 31, 1960, showed that, "because of tax differentials, the reinvestment of foreign earnings over a 3-year period can provide 'roughly double the rate of profit accumulation for reinvestment that is possible under domestic tax schedules.' "

With 52 percent domestic corporate tax rate, and with tax-haven countries having rates running down almost to zero in some instances on sales, service, and holding company income originating in third countries, the temptation to move facilities abroad, accumulate profits for reinvestment for a period of years, and only then begin to repatriate dividends on which an inadequate U.S. tax would finally

be paid, could hardly be resisted. In fact it has not been resisted and we have seen a rapid acceleration of the buildup of American direct investment abroad during the past 5 years.

Our total private investment abroad now exceeds $50 billion, and is increasing at the rate of about $5 billion per year. In the field of direct investment, and particularly with reference to tax-haven devices it is noteworthy that, according to some authorities, two-thirds of our tax-haven companies have been established within the past 5 years.

The movement of productive facilities abroad has already reached serious proportions, but even more alarming is the increasing tempo of this movement. The loss of jobs, the loss of productive facilities needed for defense and other purposes, cannot be taken lightly. It is altogether too easy for a manufacturer, when he is faced with a labor problem or with extensive replacement of machinery, to pull up stakes and move a large part of his production to a foreign country.

In this country, contrary to the practice everywhere else in the world, the direct regulation of the outflow of capital and productive facilities has always been resisted. Such direct regulation may be necessary if we are to reach a real solution. But at the very least, we must not directly and positively encourage such an outflow by giving tax concessions to those who operate abroad and thereby build up the economies of foreign countries while tearing down our own. At the very least, we should remove the tax incentive which now exists to go abroad.

There will be, even with the enactment of the tightest possible tax provisions, a continuing flow of direct investment capital and productive facilities abroad in response to economic stimuli. This will not be interfered with by this, or any other similar bill. There will also be a continuation of the outflow of other forms of capital—portfolio and short-term. These latter outflows have been troublesome during the past few years and require direct and specific regulation. This bill touches only direct investment, and touches that ever so tenderly.

Criticism has been leveled at those who wish to remove the tax incentive to take American industry and productive facilities abroad. It has been alleged that this is a new type of protectionism—a new type of isolationism.

This criticism is unwarranted, and represents the most blatant type of reverse doublethink. There is no thought, insofar as this legislation is concerned, of doing anything more than removing a positive stimulus and subsidy for American plants to be moved abroad. Of course, it may well be that this is not enough. It may be that tax neutrality may not be sufficient to slow to a tolerable rate this widespread movement of capital abroad.

Those who believe in freer trade, and who support in general the President's recommendations for legislation to improve our reciprocal trade system which has served us so well for the past 28 years, certainly cannot legitimately be accused of economic isolationism merely because they wish to achieve tax neutrality, and terminate a hurtful subsidy.

The most cruel competition which an American producer can be forced to undergo is competition from American-type goods with well-known American brand names, produced abroad by American-owned

subsidiaries which have achieved rapid growth because of the ability to dodge U.S. taxes and plow back practically all earnings, with these products distributed throughout this country through a well-established chain of wholesale and retail outlets. With a further lowering of tariffs contemplated by the trade bill now before the Finance Committee, it is certainly most inequitable to continue to give these foreign, but American-owned, producers continued tax advantages when they are competing directly with U.S. production, either in American or in foreign markets.

V

BALANCE OF PAYMENTS

It has become so fashionable to discuss any problem in terms of its effect on the balance of payments that one might properly look with suspicion on some arguments which attempt to tie balance-of-payments considerations to any possible subject matter. This has been much overdone. In the case of legislation directly affecting the flow of capital funds abroad, however, balance-of-payments considerations are certainly pertinent.

The balance-of-payments problem has been with us for some years, but has been recognized as being acute by the general public—and most Government officials—for only about the past 3 years. Prior to that time, many still talked of the dollar gap and of means of increasing the flow of capital abroad.

Although the balance-of-payments problem seems likely to be brought under control within the near future—and it must be brought under control within the next 2 or 3 years if we are to be able to avoid the use of rather drastic control methods—the problem is still acute and must be attacked from all quarters. This includes, but is not limited to, a close examination of investments made abroad by U.S. taxpayers. Those sections of the bill dealing with the taxation of profits gained from activities carried on abroad by American taxpayers will affect the balance of payments specifically and directly.

There are three principal types of capital outflows which are of concern in the balance of payments picture. Only one, that is, direct investment outflows, will be affected by the provisions of this bill. The other two, portfolio investment and short-term flows, will be little affected and must probably be dealt with in ways other than tax changes. The simplest way to deal with all three, of course, is by some system of direct licensing of capital outflows. Since we have traditionally resisted this type of regulation, however, we must be doubly sure that our tax laws are not weighted in the wrong direction. This bill does not go far enough in that regard. It does not subject income and profits earned abroad to as heavy an income tax as income and profits earned in the United States. But it does move, though haltingly and timidly, in the right direction.

There can be no question as to the effect of capital outflows on the balance of payments in the short run. There can be, of course, some question as to the long-range effects of capital outflows, particularly direct investment flows.

As to the long-range effect of direct investment outflows, the effect on the balance of payments may eventually be positive. But, with an acute situation which must be corrected within 2 or 3 years, it is

not advisable to wait for a period of years, perhaps as long as 12 to 15 years according to Treasury Department analyses, for current direct foreign investment to assist in correcting the present imbalance.

Bearing in mind that direct foreign investment is accelerating, and that the net overall balance of payments deficit this year is expected to be in the neighborhood of $1.5 billion, an alteration of investment flows in the order of a few hundred million dollars would be significant.

Reliable estimates indicate that the complete removal of the deferral privilege would, by slowing down direct investment outflows and by speeding up repatriation of earnings, decrease the balance-of-payments deficit by about $400 million annually. This bill, of course, would not be nearly so beneficial. In its present from it would be of little assistance. A good, tight, tax haven bill would assist in the balance of payments in the order of $200 to $300 million.

VI

SPECIFIC PROVISIONS

The best and indeed the only sure way to achieve substantial equity, guard against the untoward weakening of American industry and assist in the solution of the balance-of-payments problem through taxation is to tax American taxpayers annually on income and profits earned anywhere in the world. This would restore neutrality as to taxation, allowing economic forces to play their proper role in economic decisions relating to investment choices at home or abroad. This would insure that the corporation which helps to build up a depressed area in the United States would be treated as fairly by the Federal Government as the corporation which builds up the economy of Western Europe. The most important section of the subject bill dealing with foreign operations has, however, been drawn up on the theory that the partial elimination of tax haven advantages is sufficient.

There is no question that the complete elimination of tax haven operations would help materially. It is through the combination of a sales subsidiary, a service subsidiary, and a holding company located in a tax haven country, Switzerland, for example, that the U.S.-owned manufacturing company in Germany—or other relatively high-tax foreign country—is able to reduce its German tax to a rate well below the stated rate of 51 percent. If tax havens are made less profitable from a tax standpoint, the manufacturing operations which support them will have to be justified on economic grounds, not on grounds of tax avoidance, whether the taxes avoided are United States or foreign.

The Finance Committee, by approving even these imperfect provisions, does recognize that certain changes in existing law should be made.

1. It is recognized that numerous abuses exist in the operation of certain types of corporations organized in certain low-tax countries. While this tax haven problem is recognized, it is not completely corrected.

2. It is recognized that many individual U.S. citizens are living abroad for the purpose, or with the result, of escaping proper U.S. taxation. But the provisions of the bill are insufficient to deal with the problem. It will still be highly profitable, under the terms of this bill,

for a U.S. citizen to live abroad and thereby avoid paying his fair share of the cost of U.S. and free world defense and essential Government services.

3. It is recognized that there are numerous abuses in setting up foreign trusts for the purpose of escaping U.S. taxation.

4. It is recognized that there have been abuses in the liquidation of foreign corporations, with the result that accumulated ordinary income is being brought into the country in a form which allows it to be taxed at the low capital gains rate, if at all.

5. It is recognized that the U.S. estate tax has been avoided by some through the device of investing in foreign real estate, even in contemplation of death.

6. It is recognized that the law as now written allows both a partial credit and a deduction for foreign income and related taxes. For some reason, presumably because it is recognized that tax reductions do act as subsidies to draw capital investment abroad, the committee allows this double benefit to be continued in less developed countries.

7. It is recognized that present law does not require sufficiently stringent reporting of foreign economic activities of American interests.

In order for the bill to be really meaningful in correcting the imperfections in existing law which have been recognized, however, certain minimum changes must be made.

1. Section 12—Controlled foreign corporations

(*a*) This entire section, embodying as it does the tax haven approach, ought to be deleted and have substituted therefor the complete removal of the deferral privilege. Language to accomplish this objective exists in amendment 6–19–62——A to H.R. 10650, previously offered.

(*b*) The tax haven approach, if sufficiently rigorous, does represent a step forward. Should the Senate decide to proceed with this approach, this section should be amended in at least the following ways:

(1) The de minimus rule should be restored to 20 percent.

(2) The exception for export trade income of "Export Trade Corporations" should be deleted.

(3) The exception for dividend and interest income from less developed countries, together with profits realized from the sale of investments in less developed countries, should be deleted.

2. Section 9—The gross-up

This provision should be made applicable to income from subsidiary corporations operating anywhere in the world, as provided by the House-passed bill. There is no equity in allowing both a deduction and a partial credit for income taxes paid to certain countries. The operation of existing law in this area is capricious and even perverse, and is not a suitable vehicle for a subsidy, should it be felt that a subsidy is needed or desirable.

3. Section 11—Income earned abroad

There is no equity in allowing individual U.S. citizens living abroad, either temporarily or on a more permanent bona fide basis, to pay less taxes than citizens and residents here at home. All benefit from services rendered by both the U.S. Government and the government

of their host countries. All should contribute toward the cost of U.S. and free world protection. It is particularly inappropriate to allow a phasing-in of taxes on fringe benefits.

Conclusions

On balance, the bill as reported by the Finance Committee is a poor one. Although there are worthwhile sections in the bill these are hardly sufficient to outweigh those sections which are, either in whole or in part, faulty.

As we have already pointed out, many of the President's major recommendations have been ignored or watered down. The committee has chosen to strike the withholding provision, which was passed by the other body. It has failed to include in the bill such obviously needed reforms as the repeal of the dividend credit and exclusion as recommended by the President. In almost every instance, expense accounts and foreign operations, for example, where the committee did approve a section or provision recommended by the President and adopted by the House, that provision has been materially weakened.

As if the emasculation of many of the President's major recommendations were not enough, the Finance Committee has added, by way of afterthought, several rather petty addenda to the bill. Sections 21 through 26 really have no place in this bill. Some of these additions are really private bills masquerading as general legislation, while others are of such minor consequence that they have far too little stature to warrant their consideration in this bill when so many more important subjects are being left to a later, more general, tax reform bill. Some of these sections, indeed, standing alone are hardly veto proof.

The Senate must now proceed to a painstaking examination of each provision contained in this bill. We would hope that there will be full and free debate on all provisions and that each individual Senator will examine all provisions and all amendments which will be offered with care and join in an earnest endeavor to put this bill in a form more closely resembling the President's recommendations.

Should the Senate or the conference committee fail to make substantial improvements, it will be our painful duty, despite the worthwhile provisions which are contained in this bill, to oppose its final passage.

Paul H. Douglas.
Albert Gore.

[H.R. 10650] [1]

REVENUE ACT OF 1962

[Conference Report No. 2508, Eighty-seventh Congress, Second Session]

[October 1, 1962]

Mr. Mills, from the committee of conference, submitted the following Conference Report to accompany H.R. 10650.

The committee of conference on the disagreeing votes of the two Houses on the amendments of the Senate to the bill (H.R. 10650) to amend the Internal Revenue Code of 1954 to provide a credit for investment in certain depreciable property, to eliminate certain defects and inequities, and for other purposes, having met, after full and free conference, have agreed to recommend and do recommend to their respective Houses as follows:

That the Senate recede from its amendments numbered 11, 12, 13, 14, 28, 30, 50, 95, 145, 146, 197, 199, 200, and 203.

That the House recede from its disagreement to the amendments of the Senate numbered 2, 3, 4, 6, 7, 8, 10, 15, 16, 17, 18, 19, 20, 21, 22, 23, 24, 25, 26, 27, 32, 33, 34, 35, 36, 37, 38, 39, 40, 41, 42, 43, 44, 45, 46, 47, 49, 51, 52, 53, 55, 56, 57, 58, 59, 62, 63, 64, 65, 66, 67, 68, 70, 71, 72, 73, 74, 75, 76, 77, 78, 79, 80, 81, 82, 83, 84, 86, 88, 93, 94, 97, 98, 100, 101, 102, 103, 105, 106, 107, 108, 109, 110, 111, 112, 113, 114, 115, 116, 117, 118, 119, 120, 121, 122, 123, 124, 125, 127, 128, 129, 130, 131, 132, 133, 134, 135, 136, 137, 138, 139, 141, 142, 143, 144, 147, 148, 149, 150, 151, 152, 153, 154, 155, 156, 157, 158, 160, 162, 163, 164, 165, 166, 167, 168, 169, 170, 171, 172, 174, 175, 176, 177, 178, 179, 181, 182, 184, 185, 186, 188, 191, 193, and 194, and agree to the same.

Amendment numbered 1:

That the House recede from its disagreement to the amendment of the Senate numbered 1, and agree to the same with amendments as follows:

Page 3, line 6, of the Senate engrossed amendments, strike out "date" and insert *dates*

[1] **Public Law 87-834, page 111, this Bulletin,**

Page 4 of the Senate engrossed amendments, strike out lines 27 and 28 and insert:

(b) Conforming amendment.
(c) Clerical amendment.
(d) Effective date.

Page 5 of the Senate engrossed amendments, strike out lines 1 to 24, inclusive, and insert:

Sec. 27. Exclusion from gross income of certain awards made pursuant to evacuation claims of Japanese-American persons.
(a) In general.
(b) Effective date, etc.
Sec. 28. Deduction for depreciation by tenant-stockholder of cooperative housing corporation.
(a) Allowance of deduction.
(b) Clerical amendment.
(c) Effective date.
Sec. 29. Deduction for income tax purposes of contributions to certain organizations for judicial reform.
Sec. 30. Effective date of amendment to section 1374(b).
Sec. 31. Treaties.

And the Senate agree to the same.

Amendment numbered 5:

That the House recede from its disagreement to the amendment of the Senate numbered 5, and agree to the same with amendments as follows:

Page 6, line 13, of the Senate engrossed amendments, strike out "June 30, 1962" and insert *December 31, 1961*

Page 7 of the Senate engrossed amendments, strike out lines 14 to 22, inclusive, and insert:

"(4) Taxable year beginning before January 1, 1962.—For purposes of determining the amount of an investment credit carryback that may be added under paragraph (1) for a taxable year beginning before January 1, 1962, and ending after December 31, 1961, the amount of the limitation provided by subsection (a)(2) is the amount which bears the same ratio to such limitation as the number of days in such year after December 31, 1961, bears to the total number of days in such year.

And the Senate agree to the same.

Amendment numbered 9:

That the House recede from its disagreement to the amendment of the Senate numbered 9, and agree to the same with an amendment as follows:

Page 9, line 19, of the Senate engrossed amendments, after "is", insert *equal to or*; and the Senate agree to the same.

Amendment numbered 29:

That the House recede from its disagreement to the amendment of Senate numbered 29, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that such item was associated with,*

And the Senate agree to the same.

Amendment numbered 31:

That the House recede from its disagreement to the amendment of the Senate numbered 31, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *, or, in the case of an item described in subparagraph* (A) *directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), the portion of such item associated with,*

And the Senate agree to the same.

Amendment numbered 48:

That the House recede from its disagreement to the amendment of the Senate numbered 48, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *, but the amount determined under this subparagraph shall in no case be greater than the larger of—*

"(i) the amount determined under paragraph (4), or

"(ii) the amount which, when added to the amount determined under subparagraph (A), equals the amount by which 12 percent of the total deposits or withdrawable accounts of depositors of the taxpayer at the close of such year exceeds the sum of its surplus, undivided profits, and reserves at the beginning of such year (taking into account any portion thereof attributable to the period before the first taxable year beginning after December 31, 1951)

And the Senate agree to the same.

Amendment numbered 54:

That the House recede from its disagreement to the amendment of the Senate numbered 54, and agree to the same with an amendment as follows:

Page 46, after line 4, of the House engrossed bill insert:

"(5) LIMITATION IN CASE OF CERTAIN DOMESTIC BUILDING AND LOAN ASSOCIATIONS.—If the percentage of the assets of a domestic building and loan association which are not assets described in section 7701(a)(19)(D)(ii) exceeds 36 percent for the taxable year (as determined for purposes of section 7701(a)(19) for such year), the amount determined under paragraph (2), and the amount determined under paragraph (3), shall in each case be the amount (determined without regard to this paragraph but with regard to the limits contained in paragraphs (2), (3), and (1)(B)) reduced by the amount determined under the following table:

If the percentage exceeds—	*but does not exceed—*	*the reduction shall be the following proportion of the amount so determined without regard to this paragraph—*
36 percent	*37 percent*	*1/12*
37 percent	*38 percent*	*1/6*
38 percent	*39 percent*	*1/4*
39 percent	*40 percent*	*1/3*
40 percent	*41 percent*	*5/12*

And the Senate agree to the same.

Amendment numbered 60:

That the House recede from its disagreement to the amendment of the Senate numbered 60, and agree to the same with amendments as follows:

Page 24, line 15, of the Senate engrossed amendments, strike out the parenthesis at the beginning of the line.

Page 25, line 23, of the Senate engrossed amendments, strike out "(i) and (ii)" and insert *(i), (ii), (iv), and (vi)*

Page 26, line 10, of the Senate engrossed amendments, strike out "(i) and (ii)" and insert *(i), (ii), (iv), and (vi)*

Page 27, after line 6, of the Senate engrossed amendments, insert:

The term 'domestic building and loan association' also includes any association which, for the taxable year, would satisfy the requirements of the first sentence of this paragraph if '41 percent' were substituted for '36 percent' in subparagraph (E). Except in the case of the taxpayer's first taxable year beginning after the date of the enactment of the Revenue Act of 1962, the second sentence of this paragraph shall not apply to an association for the taxable year unless such association (i) was a domestic building and loan association within the meaning of the first sentence of this paragraph for the first taxable year preceding the taxable year, or (ii) was a domestic building and loan association solely by reason of the second sentence of this paragraph for the first taxable year preceding the taxable year (but not for the second preceding taxable year).

And the Senate agree to the same.

Amendment numbered 61:

That the House recede from its disagreement to the amendment of the Senate numbered 61, and agree to the same with amendments as follows:

Page 27, line 13, of the Senate engrossed amendments, strike out "EXCISE".

Page 27, line 15, of the Senate engrossed amendments, after "ACT", insert *OF 1933*

Page 27, line 16, of the Senate engrossed amendments, after "Act", insert *of 1933*

Page 27, lines 19 and 20, of the Senate engrossed amendments, strike out "EXEMPTION FROM DISCRIMINATORY STATE AND LOCAL TAXATION.—".

And the Senate agree to the same.

Amendment numbered 69:

That the House recede from its disagreement to the amendment of the Senate numbered 69, and agree to the same with amendments as follows:

Page 64, line 9, of the House engrossed bill, strike out "6047" and insert *6048*

Page 65, line 13, of the House engrossed bill, strike out "6047" and insert *6048*

Page 67, after line 6, of the House engrossed bill, strike out "6047" and insert *6048*

And the Senate agree to the same.

Amendment numbered 85:

That the House recede from its disagreement to the amendment of the Senate numbered 85, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *$500,000*; and the Senate agree to the same.

Amendment numbered 87:

That the House recede from its disagreement to the amendment of the Senate numbered 87, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following:

"*(f) Special Transitional Underwriting Loss.*—

"*(1) Companies to which subsection applies.—This subsection shall apply to every mutual insurance company which has been subject to the tax imposed by this section (as in effect before the enactment of this subsection) for the 5 taxable years immediately preceding January 1, 1962, and has incurred an underwriting loss for each of such 5 taxable years.*

"*(2) Reduction of statutory underwriting income.—For purposes of this part, the statutory underwriting income of a company described in paragraph (1) for the taxable year shall be the statutory underwriting income for the taxable year (determined without regard to this subsection) reduced by the amount by which—*

"*(A) the sum of the underwriting losses of such company for the 5 taxable years immediately preceding January 1, 1962, exceeds*

"*(B) the total amount by which the company's statutory underwriting income was reduced by reason of this subsection for prior taxable years.*

"*(3) Underwriting loss defined.—For purposes of this subsection, the term 'underwriting loss' means statutory underwriting loss, computed without any deduction under section 824(a) and without any deduction under section 832(c)(11).*

"*(4) Years to which subsection applies.—This subsection shall apply with respect to any taxable year beginning after December 31, 1962, and before January 1, 1968, for which the taxpayer is subject to the tax imposed by subsection (a).*

And the Senate agree to the same.

Amendment numbered 89:

That the House recede from its disagreement to the amendment of the Senate numbered 89, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *$1,100,000*; and the Senate agree to the same.

Amendment numbered 90:

That the House recede from its disagreement to the amendment of the Senate numbered 90, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *$1,100,000*; and the Senate agree to the same.

Amendment numbered 91:

That the House recede from its disagreement to the amendment of the Senate numbered 91, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *$500,000*; and the Senate agree to the same.

Amendment numbered 92:

That the House recede from its disagreement to the amendment of the Senate numbered 92, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *$1,100,000*; and the Senate agree to the same.

Amendment numbered 96:

That the House recede from its disagreement to the amendment of the Senate numbered 96, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *arising, either in any one State or within 200 miles of any fixed point selected by the taxpayer,*

And the Senate agree to the same.

Amendment numbered 99:

That the House recede from its disagreement to the amendment of the Senate numbered 99, and agree to the same with an amendment as follows:

Page 85, line 4, of the House engrossed bill, after "insurance", insert *company*; and the Senate agree to the same.

Amendment numbered 104:

That the House recede from its disagreement to the amendment of the Senate numbered 104, and agree to the same with amendments as follows:

Page 89, line 10, of the House engrossed bill, after "mutual fire", insert *or flood*

Page 89, line 19, of the House engrossed bill, after the period and before the quotation marks, insert *Premiums paid by the subscriber of a mutual flood insurance company referred to in paragraph (3) of section 831(a) shall be treated, for purposes of computing the taxable income of such subscriber, in the same manner as premiums paid by a policyholder to a mutual fire insurance company referred to in such paragraph (3).*

Page 90, line 18, of the House engrossed bill, after "mutual fire", insert *or flood*

And the Senate agree to the same.

Amendment numbered 126:

That the House recede from its disagreement to the amendment of the Senate numbered 126, and agree to the same with amendments as follows:

Page 62, line 7, of the Senate engrossed amendments, before "is", insert *income*

Page 64, line 24, of the Senate engrossed amendments, after "is", insert *created or*

Page 82, lines 6 and 7, of the Senate engrossed amendments, strike out "(computed without regard to section 931)"

Page 82, lines 14 and 15, of the Senate engrossed amendments, strike out "(computed without regard to section 931)"

Page 100 of the Senate engrossed amendments, strike out the table following line 10 and insert:

"If the effective foreign tax rate is (percentage)—	*The required minimum distribution of earnings and profits is (percentage)—*
Under 10	*90*
10 or over but less than 20	*86*
20 or over but less than 28	*82*
28 or over but less than 34	*75*
34 or over but less than 39	*68*
39 or over but less than 42	*55*
42 or over but less than 44	*40*
44 or over but less than 46	*27*
46 or over but less than 47	*14*
47 or over	*0*

Page 106, line 3, of the Senate engrossed amendments, strike out "total" and insert *consolidated*

Page 106, line 5, of the Senate engrossed amendments, strike out "total" and insert *consolidated*

Page 107, lines 20 and 21, of the Senate engrossed amendments, strike out "is eligible to make" and insert *makes*

And the Senate agree to the same.

Amendment numbered 140:

That the House recede from its disagreement to the amendment of the Senate numbered 140, and agree to the same with an amendment, as follows:

Page 123, line 14, of the Senate engrossed amendments, after "1962" insert a comma; and the Senate agree to the same.

(*within the meaning of section 1221*) *and has been held for more than 6*

Amendment numbered 159:

That the House recede from its disagreement to the amendment of the Senate numbered 159, and agree to the same with amendments as follows:

Page 130 of the Senate engrossed amendments, beginning with line 8, strike out all through page 131 and insert the following:

"(*b*) *Limitation on Tax Applicable to Individuals.—In the case of an individual, if the stock sold or exchanged is a capital asset* (*within the meaning of section 1221*) *and has been held for more than 6 months, the tax attributable to an amount included in gross income as a dividend under subsection* (*a*) *shall not be greater than a tax equal to the sum of—*

"(*1*) *a pro rata share of the excess of—*

"(*A*) *the taxes that would have been paid by the foreign corporation with respect to its income had it been taxed under this chapter as a domestic corporation* (*but without allowance for deduction of, or credit for, taxes described in subparagraph* (*B*)), *for the period or periods the stock sold or exchanged was held by the United States person in taxable years beginning after December 31, 1962, while the foreign corporation was a controlled foreign corporation, adjusted for distributions and amounts previously included in gross income of a United States shareholder under section 951, over*

"(*B*) *the income, war profits, or excess profits taxes paid by the foreign corporation with respect to such income; and*

"(*2*) *an amount equal to the tax that would result by including in gross income, as gain from the sale or exchange of a capital asset held for more than 6 months, an amount equal to the excess of* (*A*) *the amount included in gross income as a dividend under subsection* (*a*), *over* (*B*) *the amount determined under paragraph* (*1*).

Page 135, lines 9 and 10, of the Senate engrossed amendments, strike out "referred to in subparagraph (B)" and insert *ending on the date of the sale or exchange*

Page 137, line 25, of the Senate engrossed amendments, strike out "(2)".

And the Senate agree to the same.

Amendment numbered 161:

That the House recede from its disagreement to the amendment of the Senate numbered 161, and agree to the same with amendments as follows:

Page 139 of the Senate engrossed amendments, insert quotation marks after "apply." in line 7 and strike out lines 8 to 14, inclusive; and the Senate agree to the same.

Amendment numbered 173:

That the House recede from its disagreement to the amendment of the Senate numbered 173, and agree to the same with amendments, as follows:

Page 150, line 4, of the Senate engrossed amendments, strike out "6047" and insert *6048*

Page 150, line 6, of the Senate engrossed amendments, strike out "6048" and insert *6049*

Page 154, line 13, of the Senate engrossed amendments strike out "6048(a)(1)" and insert *6049*(*a*)(*1*)

Page 155, line 4, of the Senate engrossed amendments, strike out "6048(a)(2)" and insert *6049*(*a*)(*2*)

Page 155, line 5, of the Senate engrossed amendments, strike out "6048(a)(3)" and insert *6049*(*a*)(*3*)

Page 156, line 5, of the Senate engrossed amendments, strike out "6048(c)" and insert *6049*(*c*)

Page 156, line 8, of the Senate engrossed amendments, strike out "6048(a)(1)" and insert *6049*(*a*)(*1*)

Page 156, line 22, of the Senate engrossed amendments, strike out "6048(a)(1)" and insert *6049*(*a*)(*1*)

Page 156, line 25, of the Senate engrossed amendments, strike out "6048(a)(2), or 6048(a)(3)" and insert *6049*(*a*)(*2*), *or 6049*(*a*)(*3*)

Page 157, line 19, of the Senate engrossed amendments, strike out "6048" and insert *6049*; and the Senate agree to the same.

Amendment numbered 180:

That the House recede from its disagreement to the amendment of the Senate numbered 180, and agree to the same with an amendment as follows:

Page 159, line 18, of the Senate engrossed amendments, after "person", insert (*as defined in section 7701*(*a*)(*30*))

And the Senate agree to the same.

Amendment numbered 183:

That the House recede from its disagreement to the amendment of the Senate numbered 183, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following:

"*(e)* *LIMITATION.*—

"*(1)* *GENERAL RULE.—Except as provided in paragraph (2), no information shall be required to be furnished under this section with respect to any foreign corporation unless such information was required to be furnished under regulations which have been in effect for at least 90 days before the date on which the United States citizen, resident, or person becomes liable to file a return required under subsection (a).*

"*(2)* *EXCEPTION.—In the case of liability to file a return under subsection (a) arising on or after January 1, 1963, and before June 1, 1963—*

"*(A) no information shall be required to be furnished under this section with respect to any foreign corporation unless such information was required to be furnished under regulations in effect on or before March 1, 1963, and*

"*(B) if the date on which such regulations become effective is later than the day on which such liability arose, any return required by subsection (a) shall (in lieu of the time prescribed by subsection (d)) be filed on or before the 90th day after such date.*

And the Senate agree to the same.

Amendment numbered 187:

That the House recede from its disagreement to the amendment of the Senate numbered 187, and agree to the same with an amendment as follows:

Page 239, after line 3, of the House engrossed bill, strike out "6038(d)(2)" and insert *6038(d)(1)*; and the Senate agree to the same.

Amendment numbered 189:

That the House recede from its disagreement to the amendment of the Senate numbered 189, and agree to the same with amendments as follows:

Page 163, after line 23, of the Senate engrossed amendments, insert:

(b) CONFORMING AMENDMENT.—Section 263(a)(1) (relating to disallowance of deductions for capital expenditures) is amended by striking out "or" at the end of subparagraph (C), by striking out the period at the end of subparagraph (D) and inserting ", or", and by adding at the end thereof the following new subparagraph:

"*(E) expenditures by farmers for clearing land deductible under section 182.*"

Page 163, line 24, of the Senate engrossed amendments, strike out "(b)" and insert *(c)*

Page 164, line 4, of the Senate engrossed amendments, strike out "(c)" and insert *(d)*

And the Senate agree to the same.

Amendment numbered 190:

That the House recede from its disagreement to the amendment of the Senate numbered 190, and agree to the same with an amendment as follows:

Page 165 of the Senate engrossed amendments, strike out lines 4 through 10 and insert:

In any case in which the taxpayer elects to have the provisions of the preceding sentence apply, for purposes of computing the limitation on tax under this part—

"(1) only the same proportion of the amount to which this part applies shall be taken into account for purposes of computing the limitations under section 170(b)(1)(A) and (B) for taxable years before the taxable year in which such amount is received or accrued as (A) the excess of the maximum amount which could, if the taxpayer had made additional contributions described in clause (i), (ii), or (iii) of section 170(b)(1)(A), have been described in clause (1) of the preceding sentence over the amount described in such clause (1), bears to (B) such maximum amount, and

"(2) the portion of the amount of charitable contributions described in the preceding sentence shall not be taken into account in computing the tax for the taxable year in which the amount to which this part applies is received or accrued."

And the Senate agree to the same.

Amendment numbered 192:

That the House recede from its disagreement to the amendment of the Senate numbered 192, and agree to the same with an amendment as follows:

Page 168, of the Senate engrossed amendments, strike out lines 6 to 11, inclusive, and insert:

(b) Unused Conversion Loss Defined.—The amount of the unused conversion loss shall be the sum of the part of the net operating loss for each year described in subsection (a) which (without regard to this section) would be carried over to the sixth taxable year following the loss year if section 172(b) of the Internal Revenue Code of 1954 (or, where applicable, section 122(b)(2)(B) of the Internal Revenue Code of 1939) permitted such a carryover.

And the Senate agree to the same.

Amendment numbered 195:

That the House recede from its disagreement to the amendment of the Senate numbered 195, and agree to the same with an amendment as follows:

Page 171, line 19, of the Senate engrossed amendments, strike out "**AMERICAN-JAPANESE INDIVIDUALS**" and insert ***JAPANESE-AMERICAN PERSONS***; and the Senate agree to the same.

Amendment numbered 196:

That the House recede from its disagreement to the amendment of the Senate numbered 196, and agree to the same with amendments as follows:

Page 173, line 9, of the Senate engrossed amendments, after "**AND**", insert ***BUSINESS***

Page 174, after line 2, of the Senate engrossed amendments, insert:

(*b*) *Clerical Amendment.—The table of sections for part VII of subchapter B of chapter 1 is amended by striking out the item relating to section 216 and inserting in lieu thereof the following:*

"Sec. 216. Deduction of taxes, interest, and business depreciation by cooperative housing corporation tenant-stockholder."

Page 174, line 3, of the Senate engrossed amendments, strike out "(b)" and insert (*c*)

And the Senate agree to the same.

Amendment numbered 198:

That the House recede from its disagreement to the amendment of the Senate numbered 198, and agree to the same with an amendment as follows:

Page 177, line 2, of the Senate engrossed amendments, strike out "30" and insert *29*; and the Senate agree to the same.

Amendment numbered 201:

That the House recede from its disagreement to the amendment of the Senate numbered 201, and agree to the same with an amendment as follows:

Page 181, line 8, of the Senate engrossed amendments, strike out "33" and insert *30*; and the Senate agree to the same.

Amendment numbered 202:

That the House recede from its disagreement to the amendment of the Senate numbered 202, and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment insert the following: *31*; and the Senate agree to the same.

W. D. Mills,
Cecil R. King,
Hale Boggs,
Eugene J. Keogh,
John W. Byrnes,
Howard H. Baker,
Managers on the Part of the House.

Harry F. Byrd,
Robt. B. Kerr,
By R. S. K.
Russell B. Long,
George Smathers,
By H. F. B.
John J. Williams,
Frank Carlson,
Wallace Bennett,
Managers on the Part of the Senate.

STATEMENT OF THE MANAGERS ON THE PART OF THE HOUSE

The managers on the part of the House at the conference on the disagreeing votes of the two Houses on the amendments of the Senate to the bill (H.R. 10650) to amend the Internal Revenue Code of 1954 to provide a credit for investment in certain depreciable property, to eliminate certain defects and inequities, and for other purposes, submit the following statement in explanation of the effect of the action agreed upon by the conferees and recommended in the accompanying conference report:

The following Senate amendments made technical, clerical, clarifying, or conforming changes: 1, 2, 3, 4, 7, 8, 15, 16, 20, 22, 24, 25, 26, 27, 34, 35, 36, 38, 39, 40, 44, 47, 49, 51, 53, 55, 57, 58, 59, 63, 66, 67, 68, 71, 72, 73, 74, 77, 78, 83, 86, 88, 89, 101, 103, 105, 106, 107, 108, 109, 110, 112, 114, 115, 116, 117, 118, 119, 120, 122, 127, 134, 136, 137, 138, 139, 142, 144, 146, 148, 149, 150, 151, 152, 154, 155, 156, 157, 158, 164, 165, 169, 170, 171, 172, 174, 175, 177, 178, 182, 184, 185, 186, 187, 188, and 202. With respect to these amendments (1) the House either recedes or recedes with amendments which are technical, clerical, clarifying, or conforming in nature, or (2) the Senate recedes in order to conform to other action agreed upon by the committee of conference.

CREDIT FOR INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY

Amendments Nos. 5 and 23: Under the bill as passed by both the House and the Senate the amount of the investment credit which may be allowed for any taxable year may not exceed so much of the liability for tax for the taxable year as does not exceed $25,000, plus 25 percent of so much of the liability for tax for the taxable year as exceeds $25,000. Under the bill as passed by the House, any unused credit resulting from this limitation was to be carried forward to each of the 5 succeeding taxable years to the extent not taken into account in intervening years. Under Senate amendment No. 5, such unused credit is first carried back to the 3 preceding taxable years and then carried over to the 5 succeeding taxable years. This rule is subject to 3 exceptions: (1) The unused credit may be a carryback only to taxable years ending after June 30, 1962, (2) to the extent that an unused credit arises by reason of a net operating loss carryback, such unused credit is taken into account only as a carryover and not as a carryback from such year, and (3) in the case of a taxable year beginning before July 1, 1962, and ending after June 30, 1962, the limitation on the credit allowable for such year for purposes of the carryback to such year is the amount which bears the same ratio to the limitation otherwise applicable as the number of days in such year after June 30, 1962, bears to the total number of days in such year. The House recedes with amendments conforming the unused credit carryback provisions to the conference action on Senate amendment No. 28 (which

provides that the investment credit is to apply to taxable years ending after December 31, 1961).

Senate amendment No. 23 amends the provisions of the code relating to periods of limitation and interest to conform to the Senate amendments providing for the unused credit carryback. The House recedes.

Amendments Nos. 6 and 9: The bill as passed by the House (sec. 46(c) of the code, as added by the bill) defined the qualified investment for purposes of the investment credit as the aggregate of (1) the applicable percentage of the basis of each new section 38 property placed in service during the taxable year, plus (2) the applicable percentage of the cost of each used section 38 property placed in service during the taxable year. These applicable percentages vary according to the useful life of the property. If any such property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the useful life that was taken into account in computing the investment credit, then the income tax for the taxable year of the disposition is increased (sec. 47 of the code, as added by the bill) by an amount equal to the decrease in credits which would have resulted had the useful life used in determining the credit been the period beginning with the time the property was placed in service and ending with the time it ceased to be section 38 property.

The bill as passed by the Senate retains these rules except in cases where section 38 property is placed in service by the taxpayer to replace property which was stolen or was destroyed or damaged by fire, storm, shipwreck, or other casualty. Under Senate amendment No. 6, the basis (if new property) or cost (if used property) of the replacement section 38 property taken into account in determining qualified investment is required to be reduced by an amount equal to the amount received by the taxpayer as compensation (by insurance or otherwise) for the property destroyed, damaged, or stolen, or by an amount equal to the adjusted basis of such property, whichever is the lesser. This rule is not to apply if the reduction in qualified investment attributable to the substitution required by section 47(a)(1) of the code with respect to the property so destroyed, damaged, or stolen is greater than the reduction required under the new paragraph (4) added to section 46(c) by Senate amendment No. 6.

Senate amendment No. 9 adds a new paragraph (4) to section 47(a) of the code (relating to certain dispositions, etc., of sec. 38 property) to coordinate the provisions of such section 47(a) with the new rules provided under Senate amendment No. 6. In general, the new paragraph (4) of section 47(a) provides that paragraphs (1) and (3) of section 47(a) shall not apply to property which ceases to be section 38 property on account of its destruction or damage by fire, storm, shipwreck, or other casualty, or by reason of its theft, if such property is replaced by property to which the new paragraph (4) of section 46(c) (added by Senate amendment No. 6) applies, and if the reduction under that new paragraph is greater than the reduction in qualified investment under paragraph (1) of section 47(a).

The House recedes on Senate amendment No. 6 and recedes with a technical clarifying amendment on Senate amendment No. 9.

Amendment No. 10: This amendment adds a new paragraph (6) to new section 48(a) of the code (defining "section 38 property" for purposes of the investment credit) to provide that livestock is not to be treated as section 38 property. The House recedes.

Amendments Nos. 11, 12, 13, and 14: The bill as passed by the House defined the term "new section 38 property" as section 38 property (1) the construction, reconstruction, or erection of which is completed by the taxpayer after December 31, 1961, or (2) acquired after December 31, 1961, if the original use of such property commences with the taxpayer and commences after such date. In determining qualified investment described in clause (1) of the preceding sentence, only that portion of the basis which is properly attributable to construction, reconstruction, or erection after December 31, 1961, is to be taken into account. The bill as passed by the House also limited the definition of "used section 38 property" to property acquired by purchase after December 31, 1961. Senate amendments Nos. 11, 12, 13, and 14 changed these dates from December 31, 1961, to June 30, 1962. The Senate recedes.

Amendment No. 17: Under the bill as passed by the House, a person engaged in the business of leasing property would be permitted to elect with respect to any new section 38 property to treat the lessee as having acquired the property. Under Senate amendment No. 17, the lessor is not required to be engaged in the business of leasing property in order to make the election. The House recedes.

Amendments Nos. 18 and 19: Senate amendment No. 19 adds a new subsection (g) to new section 48 of the code (containing definitions and special rules relating to the investment credit). The new subsection requires that for purposes of subtitle A of the code (relating to income tax), other than for purposes of the investment credit, the basis of any section 38 property be reduced by an amount equal to 7 percent of the qualified investment with respect to such property. The new subsection provides, however, that if the tax under chapter 1 of the code is increased, or an adjustment in carrybacks or carryovers is made, under new section 47(a) of the code, the basis of the property is to be increased by an amount equal to the portion of the increase in tax and the portion of the adjustment attributable to such property. The House recedes.

It is the understanding of the conferees on the part of both the House and the Senate that the purpose of the credit for investment in certain depreciable property, in the case of both regulated and nonregulated industries, is to encourage modernization and expansion of the Nation's productive facilities and to improve its economic potential by reducing the net cost of acquiring new equipment, thereby increasing the earnings of the new facilities over their productive lives.

Senate amendment No. 18 provides that if a lessor makes an election to treat the lessee as having acquired the property then, under regulations prescribed by the Secretary of the Treasury or his delegate, the new subsection (g) added by amendment No. 19 is not to apply and the deductions otherwise allowable under section 162 of the code to the lessee for amounts paid to the lessor under the lease are to be adjusted in a manner consistent with the provisions of the new subsection (g). The House recedes.

Amendment No. 21: This amendment adds a new section 2(c) to the bill, adding a new section 181 to part VI of subchapter B of chapter 1 of the code (relating to itemized deductions for individuals and corporations). If after applying the carrybacks and carryovers of any unused investment credit any amount thereof remains unused, this amount is to be allowed to the taxpayer as a deduction for the first taxable year following the last taxable year in which the unused

amount could have been allowed as a credit. However, if a taxpayer dies or ceases to exist before such first taxable year, the amount described in the preceding sentence (or proper portion thereof) is, under regulations, to be allowed to the taxpayer as a deduction for the taxable year in which such death or cessation occurs. The House recedes.

Amendment No. 28: Under the bill as passed by the House, the amendments made by section 2 (relating to credit for investment in certain depreciable property) were to apply with respect to taxable years ending after December 31, 1961. Under Senate amendment No. 28, the amendments were to apply with respect to taxable years ending after June 30, 1962. The Senate recedes.

DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES

Amendments Nos. 29, 30, and 31: The bill as passed by both the House and the Senate adds a new section 274 to the code (relating to disallowance of certain entertainment, etc., expenses). Section 274(a)(1) as passed by the House provided that no deduction otherwise allowable under chapter 1 of the code is to be allowed for any item—

> (1) with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes that the item was directly related to the active conduct of the taxpayer's trade or business, or
>
> (2) with respect to a facility used in connection with such an activity, unless the taxpayer establishes that the facility was used primarily for the furtherance of the taxpayer's trade or business and that the item was directly related to the active conduct of such trade or business,

and such deduction is in no event to exceed the portion of such item directly related to the active conduct of the taxpayer's trade or business.

Senate amendments Nos. 29, 30, and 31 inserted the words "or associated with" after the words "directly related to" each place they appeared in the new section 274(a)(1) as passed by the House.

Under the conference agreement the House recedes on Senate amendment No. 29 with an amendment providing that deductions otherwise allowable under chapter 1 of the code shall not be allowed for any item with respect to an entertainment type activity "unless the taxpayer establishes that the item was directly related to, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that such item was associated with," the active conduct of the taxpayer's trade or business. Under the conference agreement, the Senate recedes on amendment No. 30, and the House recedes on amendment No. 31 with an amendment conforming to the action on amendment No. 29.

The rule of the House bill as described in the report of the Committee on Ways and Means is more strict than the "or associated with" rule of the Senate amendment. The rule of the House bill would not allow deduction of expenditures for entertainment occurring under circumstances where there is little or no possibility of conducting business affairs or carrying on negotiations or discussions relating thereto, such as where the group of persons entertained is large or the distractions substantial.

It is the understanding of the conferees, both on the part of the House and the Senate, that the alternative Senate "or associated with" test as described in the report of the Finance Committee would apply to certain entertaining primarily to encourage goodwill where the evidence of business connection is clear, whether or not business is actually transacted or discussed during the entertainment. The conference agreement would permit a deduction for the cost of an entertainment item, even though the item is not directly related to the active conduct of the taxpayer's trade or business, if the item is associated with it, so long as the entertainment activity directly precedes or follows a substantial and bona fide business discussion. The conditions under which an item is "associated with" the active conduct of a trade or business are contained in the report of the Committee on Finance. The deductibility of other items of entertainment expense, as well as items with respect to facilities, would be governed by the rule of the House bill.

Section 274(a) as agreed to by the conferees will allow as a deduction the cost of entertaining connected with what are primarily business meetings. For example, if the taxpayer conducts substantial negotiations with a group of business associates and that evening entertains the group and their wives at a restaurant, theater, concert, or sporting event, such entertainment expenses, if associated with the active conduct of the taxpayer's business, will be deductible even though the purpose of the entertainment is merely to promote goodwill in such business. Moreover, if a group of business associates with whom the taxpayer is conducting business meetings comes from out of town to the taxpayer's place of business to hold substantial business discussions, the entertainment of such business guests by the taxpayer the evening prior to the business discussions will be regarded as directly preceding the business discussions.

Similarly, if in between, or in the evenings after, business meetings at a convention, the taxpayer entertains his business associates or prospective customers attending such meetings (and their wives), such entertainment will be considered as directly preceding or following a business discussion.

Any entertainment which is a part of substantial and bona fide business discussions, where the conduct of business is the principal activity during the combined entertainment and business time spent together by the taxpayer and the person or persons entertained, will be deductible if the expense is associated with the active conduct of the taxpayer's trade or business.

Also, the cost of banquets at meetings of professional and business associations would normally be deductible. As in the above cases, if the expense is associated with the active conduct of a trade or business, it would not be necessary for the person paying for the banquet to attend the banquet himself. For example, a dental equipment supplier would be able to deduct the cost of purchasing a table at a dental association banquet for dentists who are actual or prospective customers for his equipment.

Thus, under the business meal exception contained in proposed section 274(e)(1), and the conference agreement, the cost of providing food and beverages at most business meetings and banquets would be deductible, as well as almost all restaurant and most hotel entertaining. In neither of the situations covered by the conference agreement

nor under the business meal exception is there a requirement that business must actually be discussed in order to get a deduction.

Amendment No. 32: Section 274(b), as added to the code by the bill as passed by both the House and the Senate, provides in effect that no deduction is to be allowed under section 162 or 212 of the code for any expense for gifts to any individual to the extent that the total expenses of the taxpayer for gifts to such individual during the same taxable year exceed $25. For purposes of the new section 274, the term "gift" is defined to mean any item excludable from gross income of the recipient under section 102 of the code which is not excludable from his gross income under any other provision of chapter 1 of the code. Senate amendment No. 32 adds a new provision providing that such term does not include—

(1) an item having a cost to the taxpayer not in excess of $4 on which the name of the taxpayer is clearly and permanently imprinted and which is one of a number of identical items distributed generally by the taxpayer,

(2) a sign, display rack, or other promotional material to be used on the business premises of the recipient, or

(3) an item of tangible personal property having a cost to the taxpayer not in excess of $100 which is awarded to an employee by reason of length of service or for safety achievement.

The House recedes.

Amendment No. 33: This amendment adds a new subsection (c) to the new section 274 added to the code by the bill. The new subsection (c) provides that in the case of any individual who is traveling away from home in pursuit of a trade or business or in pursuit of an activity described in section 212 of the code (relating to expenses for production of income), no deduction is to be allowed under section 162 or 212 for that portion of the expenses of such travel otherwise allowable under such section which, under regulations prescribed by the Secretary of the Treasury or his delegate, is not allocable to such trade or business or to such activity. The new subsection (c) is not to apply to the expenses of any travel away from home which does not exceed 1 week or where the portion of the time away from home which is not attributable to the pursuit of the taxpayer's trade or business or an activity described in section 212 is less than 25 percent of the total time away from home on such travel. The House recedes.

Amendment No. 37: Under subsection (e)(6) of the new section 274 of the code, as added by the bill as passed by the House, section 274(a) (relating to disallowance of entertainment, amusement, or recreation expenses) was not to apply to expenses directly related to business meetings of employees or stockholders. Under Senate amendment No. 37, section 274(a) is not to apply to expenses incurred by a taxpayer which are directly related to business meetings of his employees, stockholders, agents, or directors. Under this provision, the members of a partnership are to be considered as agents. The House recedes.

Amendment No. 41: Section 162 of the code provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including "traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business." Under the bill as passed by the House, the

parenthetical matter quoted in the preceding sentence would be changed to "(including a reasonable allowance for amounts expended for meals and lodging)". Under Senate amendment No. 41, such parenthetical matter would be changed to "(including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances)". The House recedes.

Amendment No. 42: Under the bill as passed by the House, the amendments made by the bill with respect to the disallowance of certain entertainment, etc., expenses were to apply with respect to taxable years ending after June 30, 1962, but only in respect of periods after such date. Under Senate amendment No. 42, the amendments are to apply with respect to taxable years ending after December 31, 1962, but only in respect of periods after such date. The House recedes.

AMOUNT OF DISTRIBUTION WHERE CERTAIN FOREIGN CORPORATIONS DISTRIBUTE PROPERTY IN KIND

Amendment No. 43: Subsection (d) of section 5 of the bill as passed by the House would amend section 902(a) of the code (relating to credit for foreign taxes) to provide that for purposes of section 902 (a) and (b) the amount of any distribution in property other than money is to be determined under section 301(b)(1)(B) of the code. Under section 301(b)(1)(B) the amount of a distribution of property to a corporate shareholder is the lesser of (1) the fair market value of such property, or (2) the adjusted basis of such property (in the hands of the distributing corporation immediately before the distribution). Senate amendment No. 43 strikes out subsection (d) of section 5 of the bill. The House recedes.

AMENDMENT TO SECTION 482 OF THE INTERNAL REVENUE CODE

Amendment No. 45: Section 6 of the bill as passed by the House amended section 482 of the code (relating to allocation of income and deductions among taxpayers) by designating the existing text as subsection (a) and by adding a new subsection (b) to provide special rules for allocating taxable income, arising from sales of tangible property within a related group which includes a foreign organization, among the members of the group. The allocation was to be made by the Secretary of the Treasury or his delegate by taking into consideration that portion of the factors listed in the bill which is attributable to the United States and that portion which is not attributable to the United States. The bill also permitted consideration of other factors (including special risks, if any, of the market in which the property is sold). If the taxpayer established to the satisfaction of the Secretary or his delegate that an alternative method of allocation clearly reflects the income of each member of the group with respect to the property in question, the alternative method was required to be used.

Senate amendment No. 45 strikes out section 6 of the bill as passed by the House.

The House recedes. The conferees on the part of both the House and the Senate believe that the objectives of section 6 of the bill as passed by the House can be accomplished by amendment of the regulations under present section 482. Section 482 already contains broad authority to the Secretary of the Treasury or his delegate to allocate

income and deductions. It it believed that the Treasury should explore the possibility of developing and promulgating regulations under this authority which would provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income.

DISTRIBUTIONS OF FOREIGN PERSONAL HOLDING COMPANY INCOME

Amendment No. 46: Section 7 of the bill as passed by the House amended section 552(a) of the code to substitute a 20-percent gross income requirement for the requirement now contained in the definition of a foreign personal holding company that more than 60 percent (or 50 percent in certain cases) of its gross income consist of foreign personal holding company income. Such section 7 also amended the definition of "undistributed foreign personal holding company income" contained in section 556(a) of the code to mean taxable income (adjusted as provided by existing law) if the foreign personal holding company income exceeds 80 percent of the company's gross income, and to mean a proportionate part of such taxable income if the foreign personal holding company income does not exceed 80 percent of its gross income.

Senate amendment No. 46 strikes out section 7 of the bill as passed by the House. The House recedes.

MUTUAL SAVINGS BANKS, ETC.

Amendment No. 48: The bill as passed by both the House and the Senate amends section 593 of the code to provide rules relating to reserves for losses on loans by mutual savings institutions listed in the bill. Subsection (b)(1) of the amended section 593 prescribes the method for determining the reasonable addition for the taxable year to the reserve for bad debts under section 166(c) of the code and also specifies the reserves to which such additions are to be made. Such reasonable addition is the sum of two amounts—(1) the amount determined under section 166(c) to be the reasonable addition to the reserve for losses on nonqualifying loans, plus (2) the amount determined by the taxpayer to be a reasonable addition to the reserve for losses on qualifying real property loans (but the amount so determined by the taxpayer is not to exceed the amount determined under pars. (2), (3), or (4) of sec. 593(b), whichever amount is the largest). Senate amendment No. 48 adds a further limitation providing that the amount of the addition for a taxable year to the reserve for losses on qualifying real property loans, when added to the amount of the addition to the reserve for losses on nonqualifying loans, shall in no case be greater than the amount by which 12 percent of the total deposits or withdrawable accounts of depositors of the taxpayer at the close of such year exceeds the sum of its surplus, undivided profits, and reserves at the beginning of such year (taking into account any portion thereof attributable to the period before the first taxable year beginning after December 31, 1951). The House recedes with a substitute for the Senate amendment which provides, in effect, that the 12-percent ceiling is not to apply in the case of a taxpayer using the experience method for the taxable year.

Amendments Nos. 50 and 52: Under section 593(b)(2) of the code as amended by the bill as passed by the House, the amount of the

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reasonable addition to the reserve for losses on qualifying real property loans for a taxable year was limited to the excess of an amount equal to 60 percent of the taxable income for such year over the amount determined under section 166(c) to be a reasonable addition to the reserve for losses on nonqualifying loans. For purposes of this method, taxable income is determined without regard to any deduction for any additions to the reserves for bad debts, and also by excluding from gross income any amount included therein by reason of subsection (f) (relating to the treatment of certain distributions of property to stockholders by a domestic building and loan association).

Senate amendment No. 50 provided that, in the case of a domestic building and loan association having capital stock with respect to which any distribution of property is not allowable as a deduction under section 591 (relating to dividends paid on deposits), an amount equal to 50 percent of the taxable income is substituted for the 60 percent provided by the bill as passed by the House. The Senate recedes.

Senate amendment No 52 provides that the amount of the addition determined under section 593(b)(2) is not to exceed the amount necessary to increase the balance (as of the close of the taxable year) of the reserve for losses on qualifying real property loans to 6 percent of such loans outstanding at such time. The House recedes.

Amendment No. 54: Under section 593(b)(3) of the code as amended by the bill as passed by the House, the amount of the reasonable addition to the reserve for losses on qualifying real property loans for a taxable year was limited to an amount equal to the amount necessary to increase the balance (as of the close of the taxable year) of such reserve to 3 percent of such loans outstanding at such time. Senate amendment No. 54 permits the balance of the reserve for losses on qualifying real property loans to be increased to a larger amount in the case of a mutual savings institution which is a new company and which does not have capital stock with respect to which distributions of property are not allowable as a deduction under section 591 of the code. This larger amount is the sum of two amounts: (1) 3 percent of qualifying real property loans outstanding at the close of the taxable year, plus (2) an amount equal to 2 percent of so much of such loans as does not exceed $4,000,000, reduced (but not below zero) by the amount, if any, of the balance (as of the close of such year) of the taxpayer's supplemental reserve for losses on loans. A taxpayer is a "new company" for any taxable year only if such taxable year begins not more than 10 years after the first day on which it (or any predecessor) was authorized to do business as a mutual savings institution described in section 593(a) of the code.

The House recedes with an amendment. Under the conference action the text of section 593(b)(3) of the code is the same as it is under Senate amendment numbered 54. In addition, under the conference action the new section 593(b)(5) of the code provides that in the case of certain domestic building and loan associations there will be a reduction in the amount determined under paragraph (2) (60 percent of taxable income method) and paragraph (3) (percentage of real property loans method) of section 593(b). For purposes of computing this reduction, the amount determined under paragraph (2), and the amount determined under paragraph (3), shall in each case be the amount determined without regard to the new section 593(b)(5), but with regard to the 12-percent ceiling added by Senate amendment

numbered 48 and, in the case of the amount determined under paragraph (2), the 6-percent ceiling added by Senate amendment numbered 52. The reduction provided by the new section 593(b)(5) will apply only in the case of a domestic building and loan association which qualifies as such for the taxable year solely by reason of the second sentence of section 7701(a)(19) (see the discussion of Senate amendment numbered 60), which changes the 36-percent requirement of subparagraph (E) of the first sentence of section 7701(a)(19) to a 41-percent requirement. The reduction varies from one-twelfth to five-twelfths, depending on the number of percentage points (and fractions thereof) by which the association fails to satisfy the 36-percent requirement.

Amendment No. 56: Section 593(c) of the code, as amended by the bill as passed by the House provides for the allocation of pre-1963 reserves (that is, the net amount, determined as of December 31, 1962, accumulated in the reserve for bad debts for taxable years beginning after December 31, 1951)—

(1) first, to the reserve for losses on nonqualifying loans, to the extent such reserve is not increased above the amount which would be a reasonable addition under section 166(c) of the code for a period in which such loans increased from zero to the amount outstanding at the close of 1962,

(2) second, to the reserve for losses on qualifying real property loans, to the extent such reserve is not increased above the amount equal to 3 percent of the loans outstanding at the close of 1962 or, if larger, the amount which would be a reasonable addition under section 166(c) of the code for a period in which such loans increased from zero to the amount outstanding at the close of 1962, and

(3) then to a supplemental reserve for losses on loans.

Senate amendment No. 56 adds a new paragraph (5) to section 593(c) providing, in effect, that if the pre-1963 reserves are insufficient to bring the balance of the reserve for qualifying real property loans up to the amount referred to in paragraph (2) above then the term "pre-1963 reserves" includes so much of the surplus, undivided profits, and bad debt reserves (determined as of Dec. 31, 1962) attributable to the period before the first taxable year beginning after December 31, 1951, as is necessary to bring the balance of the reserve for qualifying real property loans up to the amount referred to in paragraph (2) above. This rule is to apply only for the purpose of determining reasonable additions under the amended section 593 to such reserve, and for such purpose the amount so allocated is to be treated as remaining in such reserve. The House recedes.

Amendment No. 60: Section 7701(a)(19) of the code defines the term "domestic building and loan association" as a domestic building and loan association, a domestic savings and loan association, and a Federal savings and loan association, substantially all of the business of which is confined to making loans to members.

The bill as passed by the House amended section 7701(a)(19) to provide that the term "domestic building and loan association" means any domestic building and loan association, domestic savings and loan association, and Federal savings and loan association which met each of two requirements. The first requirement was that the association be either (i) an insured institution within the meaning of section 401(a) of the National Housing Act, or (ii) subject by law to supervision and

examination by State or Federal authority having supervision over such associations. The second requirement was that substantially all of the business of the association must consist of accepting savings and investing the proceeds in (i) loans secured by an interest in real property which is, or from the proceeds of the loan will become, residential real property, and (ii) other loans to the extent they would be authorized to be made by a Federal savings and loan association under section 5(c) of the Home Owners' Loan Act of 1933.

Senate amendment No. 60 adopts without change the first requirement of the bill as passed by the House, but replaces the second requirement with six new requirements:

(1) Substantially all of the business of the association must consist of acquiring the savings of the public and investing in loans described in paragraph (2) below.

(2) At least 90 percent of the amount of the total assets (determined as of the close of the taxable year) of the association must consist of (i) cash, (ii) obligations of the United States, a State, or a political subdivision of a State, stock or obligations of a corporation which is an instrumentality of one of those governmental units, and certificates of deposit in, or obligations of, a corporation organized under a State law which specifically authorizes such corporation to insure the deposit or share accounts of member associations, (iii) loans secured by an interest in real property and loans made for the improvement of real property, (iv) loans secured by a deposit or share of a member, (v) property acquired through the liquidation of defaulted loans described in clause (iii) of this paragraph, and (vi) property used by the association in the conduct of the business described in paragraph (1) above.

(3) Of the assets taken into account as assets constituting the 90 percent of total assets, at least 80 percent of such 90 percent must consist of (i) assets of the types described in clauses (i) and (ii) of paragraph (2) above, and (ii) loans secured by an interest in real property which is, or from the proceeds of the loan will become, residential real property or real property used primarily for church purposes, loans made for the improvement of residential real property or real property used primarily for church purposes, or property acquired through the liquidation of defaulted loans described in this paragraph.

(4) Of the assets taken into account as assets constituting the 90 percent of total assets, at least 60 percent of such 90 percent must consist of (i) assets of the types described in clauses (i) and (ii) of paragraph (2) above, and (ii) loans secured by an interest in real property which is, or from the proceeds of the loan will become, residential real property containing four or fewer family units or real property used primarily for church purposes, loans made for the improvement of residential real property containing four or fewer family units or real property used primarily for church purposes, or property acquired through the liquidation of defaulted loans described in this paragraph.

(5) Not more than 18 percent of the amount of the total assets (determined as of the close of the taxable year) of the association may consist of assets other than those referred to in paragraph (3) above, and not more than 36 percent of the amount of such total assets may consist of assets other than those referred to in paragraph (4) above.

(6) Except for property described in paragraph (2) above, not more than 3 percent of the total assets of the association may consist of stock of any corporation.

Senate amendment No. 60 also provides that, at the election of the association, the percentages specified in paragraph (2) through (6) above shall be applied on the basis of the average assets outstanding during the taxable year, rather than at the close of the taxable year, as computed under regulations prescribed by the Secretary of the Treasury or his delegate.

The House recedes with amendments. Under the conference action, loans secured by a deposit or share of a member, and property used by the association in the conduct of its savings and loan business, are in effect to be taken into account (1) in the same manner as loans on residential real property for purposes of section 7701(a)(19)(D)(i), and (2) in the same manner as loans on residential real property for four or fewer family units for purposes of section 7701(a)(19)(D)(ii).

Under the conference action, a second sentence and a third sentence are added to section 7701(a)(19). The new second sentence provides that the term "domestic building and loan association" also includes any association which would satisfy the requirements of the first sentence if "41 percent" were substituted for "36 percent" in subparagraph (E) of the first sentence. The new third sentence provides in effect that, except in the case of the association's first taxable year (whenever occurring in the case of a new association) beginning after the date of the enactment of the bill, the modification of the 36-percent requirement is to be available to it for a taxable year only if—

(1) it met the requirements of the first sentence of section 7701(a)(19) for the immediately preceding taxable year, or

(2) it qualified as a domestic building and loan association for the immediately preceding taxable year solely by reason of the second sentence of section 7701(a)(19) and (if the taxable year is the third or any succeeding taxable year of the association beginning after the date of the enactment of the bill) it met the requirements of the first sentence of section 7701(a)(19) for the second preceding taxable year.

Amendment No. 61: The bill as passed by the House repealed the exemption of Federal savings and loan associations from the taxes imposed by sections 4251 and 4261 of the code (relating, respectively, to the excise tax on communications and the excise tax on the transportation of persons). Senate amendment No. 61 amends section 5(h) of the Home Owners' Loan Act of 1933 (12 U.S.C., sec. 1464(h)) so as to eliminate entirely the exemptions from Federal taxes which that section now provides in the case of Federal savings and loan associations.

Under section 4382(a)(2) of the code, capital stock and certificates of indebtedness issued by domestic building and loan associations and cooperative banks are exempt from the documentary stamp taxes imposed by chapter 34 of the code. Senate amendment No. 61 amends section 4382(a)(2) so as to eliminate this exemption insofar as it extends (i) to all certificates of indebtedness issued by a domestic building and loan association or cooperative bank, and (ii) to shares or certificates of stock issued by such a domestic building and loan association or cooperative bank, to the extent that such shares or certificates of stock do not represent deposits or withdrawable accounts.

The House recedes with clerical and clarifying amendments.

Amendment No. 62: This Senate amendment adds a new provision to the bill as passed by the House which would amend section 591 of the code (relating to the deduction for dividends paid on deposits by mutual savings banks, cooperative banks, and domestic building and loan associations) so as to make clear that a deduction will be allowable under section 591 for (1) interest paid or credited to the accounts of depositors or holders of accounts on their deposits or withdrawable accounts by mutual savings banks, cooperative banks, and domestic building and loan associations, and (2) dividends and interest described in section 591 paid by a savings institution chartered and supervised as a savings and loan or similar association under Federal or State law. The House recedes.

Amendment No. 64: Under the bill as passed by the House, the change in the definition of the term "domestic building and loan association" would have taken effect on the enactment of the bill. Senate amendment No. 64 adds a new provision under which the new definition will apply to taxable years beginning after the date of the enactment of the bill. The House recedes.

Amendment No. 65: The bill as passed by the House provided an effective date of July 1, 1962, for the termination of the exemption of domestic building and loan associations from the excise taxes on communications and transportation of persons. Senate amendment No. 65 provides an effective date of January 1, 1963, for the termination, resulting from Senate amendment No. 61 of exemptions from Federal taxes. The House recedes.

DISTRIBUTIONS BY FOREIGN TRUSTS

Amendment No. 69: The bill as passed by the House defined the term "foreign trust created by a United States person" (for purposes of the provisions of the bill relating to distributions by foreign trusts) as, in general, a foreign trust to which money or property has been transferred directly or indirectly by a United States person, or under the will of a decedent who at the date of his death was a United States citizen or resident. Senate amendment No. 69 provides that such term means that portion of a foreign trust attributable to money or property transferred directly or indirectly by such a person or under the will of such a decedent. The House recedes with clerical amendments.

Amendment No. 70: Under the bill as passed by the House, the amendments to subchapter J of chapter 1 of the code with respect to distributions by foreign trusts were to apply with respect to distributions made in taxable years of trusts beginning after the date of the enactment of the bill. Senate amendment No. 70 provides that these amendments are to apply with respect to distributions made after December 31, 1962. The House recedes.

MUTUAL INSURANCE COMPANIES (OTHER THAN LIFE, MARINE, AND CERTAIN FIRE OR FLOOD INSURANCE COMPANIES)

Amendments Nos. 75 and 76: These are amendments to conform, in the case of insurance companies subject to tax under part II of subchapter L of chapter 1 of the code, the normal tax rates on mutual insurance company taxable income and on taxable investment income to the action taken by the Congress in the Tax Rate Extension Act of 1962. The House recedes.

Amendments Nos. 79, 80, 81, 82, and 102: Under existing law and under the bill as passed by the House, mutual insurance companies other than life or marine are exempt from income tax if the gross amount received from specified items does not exceed $75,000. Under the bill as passed by the House, if this gross amount is over $75,000 but less than $125,000, the alternative tax imposed by the new section 821(c)(1) of the code on small companies is proportionately reduced. Under Senate amendment No. 102, a mutual insurance company other than life or marine is exempt from income tax if the gross amount does not exceed $150,000. Senate amendments Nos. 79, 80, 81, and 82 provide for a proportionate decrease in the alternative tax if the gross amount is over $150,000 but less than $250,000. The House recedes.

Amendments Nos. 84 and 85: Under the bill as passed by the House, the alternative tax for certain small companies provided by the new section 821(c) of the code applied for a taxable year only if the gross amount referred to in section 821(c)(3) for the taxable year exceeded $75,000 but did not exceed $300,000. Under Senate amendments Nos. 84 and 85 the $75,000 and $300,000 amounts are changed to $150,000 and $600,000, respectively. The House recedes on Senate amendment No. 84. The House recedes on Senate amendment No. 85 with an amendment changing the $600,000 amount provided by the Senate amendment to $500,000.

Amendment No. 87: This amendment adds a new subsection (f) to section 821 of the code and provides a special transitional underwriting loss deduction for taxable years beginning after 1962 and before 1968 for mutual insurance companies which were subject to the tax imposed by existing section 821 for the 6 taxable years immediately preceding 1963 and which incurred an underwriting loss for at least 5 of such 6 years. The mutual insurance company taxable income with respect to such a company is reduced each year by the amount by which (1) the sum of the underwriting losses of such company for such 6 years, reduced by the underwriting gain for such years, exceeds (2) the total amount by which mutual insurance company taxable income was reduced under the new subsection (f) for prior taxable years. The House recedes with a substitute under which (1) the new subsection (f) applies only in the case of a company which has been subject to the tax imposed by section 821 for each of the 5 taxable years immediately preceding 1962, and has incurred an underwriting loss for each of such 5 taxable years, and (2) such losses are to be used as an offset only to statutory underwriting income.

Amendments Nos. 90, 91, and 92: Section 823(c) of the code, as added by the bill as passed by the House, provided a special deduction (not to exceed $6,000 in amount) in determining the statutory underwriting income or loss for the taxable year if the gross amount received from the items specified in section 823(c) does not equal or exceed $900,000. Under Senate amendments Nos. 90, 91, and 92 this special deduction decreases to zero when the gross amount equals $1,200,000. The House recedes with an amendment under which the deduction decreases to zero when the gross amount equals $1,100,000.

Amendments Nos. 93, 94, 95, and 96: Under the bill as passed by the House, paragraph (1) of the new section 824(a) added to the code (relating to deduction to provide protection against losses) provides

that in determining the statutory underwriting income or loss for any taxable year there is to be allowed as a deduction the sum of—

(1) an amount equal to 1 percent of the losses incurred during the taxable year, plus

(2) an amount equal to 25 percent of the underwriting gain for the taxable year, plus

(3) if the concentrated windstorm, etc., premium percentage (as defined in the bill) for the taxable year exceeds 50 percent, an amount determined by applying so much of such percentage as exceeds 50 percent to the underwriting gain for the taxable year.

Under the bill as passed by the House, paragraph (2) of the new section 824(a) defines the term "concentrated windstorm, etc., premium percentage" as the percentage obtained by dividing (A) premiums earned on insurance contracts during the taxable year, to the extent attributable to insuring against losses arising in any one State, from windstorm, hail, flood, earthquake, or similar hazards, by (B) premiums earned on insurance contracts during the taxable year.

Senate amendments Nos. 93 and 94 increase the scope of the coverage of paragraph (3) above and increase the amount of the deduction by striking out the references to 50 percent and inserting in lieu thereof 40 percent. The House recedes.

Senate amendment No. 96 changes the definition of "concentrated windstorm, etc., premium percentage" to permit the percentage to be determined by reference to premiums attributable to insuring against losses arising (1) in any one State, (2) if the taxpayer so elects, within 200 miles of any fixed point selected by the taxpayer, or (3) if the taxpayer so elects, within 400 miles of any fixed point selected by the taxpayer. Senate amendment No. 95 provides that, in the case of a taxpayer making the election described in clause (3) of the preceding sentence, the amount of the deduction allowable by reason of section 824(a)(1)(C) is to be one-half of the amount it would be but for this amendment. The House recedes on Senate amendment No. 96 with an amendment under which the percentage is to be determined by reference to premiums attributable to losses arising either (1) in any one State, or (2) within 200 miles of any fixed point selected by the taxpayer. The Senate recedes on Senate amendment No. 95.

Amendments Nos. 97, 98, and 99: Subsection (d) of the new section 824 of the code, as added by the bill, sets forth the amounts which are to be subtracted from the protection against loss account. These amounts are taken into account for purposes of determining mutual insurance company taxable income.

Under the bill as passed by the House, the first subtraction from the account was to be made for so much of the statutory underwriting loss as was generated either by the deduction for dividends to policyholders or by the deduction provided in section 824(a) for protection against losses. Thus, under the bill as passed by the House, any underwriting loss attributable to policy dividends could not be applied against taxable investment income unless the balance in the protection against loss account had first been reduced to zero.

The effect of Senate amendments Nos. 97, 98, and 99 is to permit any portion of the statutory underwriting loss attributable to the deduction for dividends to policyholders to be first applied against

taxable investment income. The House recedes on Senate amendments Nos. 97 and 98, and recedes on Senate amendment No. 99 with a clerical amendment.

Amendment No. 100: New section 826 of the code, as added by the bill, in effect permits a mutual insurance company which is an inter-insurer or reciprocal underwriter to elect to combine certain income of its attorney-in-fact with its own underwriting income. If the company so elects, it is credited with so much of the tax paid by the attorney-in-fact as is attributable to such income of the attorney-in-fact. Under the bill as passed by the House, subsection (d) of section 826 provided, in effect, that the protection against loss deduction of the reciprocal making the election and the addition to its protection against loss account were to be computed without regard to the election. Senate amendment No. 100 strikes out this provision, thus permitting the protection against loss deduction, and the amount added to the protection against loss account, to reflect amounts attributable to such income of the attorney-in-fact. The amendment inserts a new subsection (d) providing, in effect, that no part of the amount added to the protection against loss account by reason of the election by the reciprocal may remain in the account (and thus be subject to tax deferral) for more than 5 years. The House recedes.

Amendment No. 104: Under this amendment (and Senate amendment No. 74) mutual flood insurance companies are to be taxed under part III of subchapter L of chapter 1 of the code (which imposes a tax on certain marine and mutual fire insurance companies and on certain stock insurance companies which are not life insurance companies).

The House recedes with technical conforming amendments making it clear that the taxation of these mutual flood insurance companies (and of their subscribers or policyholders) is to be the same as the present tax treatment of so-called factory mutuals (and of their policyholders).

DOMESTIC CORPORATIONS RECEIVING DIVIDENDS FROM FOREIGN CORPORATIONS

Amendments Nos. 111 and 113: These amendments deal with (1) the method to be used for determining the amount of foreign income tax deemed to have been paid by domestic corporations with respect to dividends received from foreign corporations for purposes of the allowance of a foreign tax credit under section 902 of the code, and (2) the amount to be treated as received as a dividend by reason of the tax so deemed paid. Under the bill as passed by the House, the entire amount of foreign income tax of the foreign corporation was to be taken into account in determining the foreign income tax deemed to be paid by the domestic corporation, and (under new sec. 78) an amount equal to the taxes deemed paid was required to be included in income as a dividend. Senate amendment No. 111 would (A) retain existing law with respect to dividends paid by a foreign corporation out of accumulated profits of a year for which it is a "less developed country corporation," and (B) provide, with respect to all other dividends paid by a foreign corporation, the same rules as were provided by the bill as passed by the House. Under Senate amendment No. 113, the new section 78 is amended to exclude from the application of the new section 78 dividends referred to in clause (A) above. The House recedes on Senate amendments Nos. 111 and 113.

SEPARATE LIMITATION ON FOREIGN TAX CREDIT WITH RESPECT TO CERTAIN INTEREST INCOME

Amendment No. 121: Section 904 of the code provides a per-country limitation on the amount of the foreign tax credit or (at the election of the taxpayer) an overall limitation may be applied. Senate amendment No. 121 adds a new section to the bill to provide a separate limitation on the foreign tax credit with respect to certain interest income. Under the amendment, (1) the foreign tax credit limitations are to be applied separately with respect to (A) certain interest income, and (B) income other than such interest income, and (2) the overall limitation is not to apply to such interest income. The interest income referred to is any interest other than—

(A) interest derived from any transaction which is directly related to the active conduct of a trade or business in a foreign country or a possession of the United States,

(B) interest derived in the conduct of a banking, financing, or similar business,

(C) interest received from a corporation in which the taxpayer owns at least 10 percent of the voting stock, and

(D) interest received on obligations acquired as a result of the disposition of a trade or business actively conducted by the taxpayer in a foreign country or a possession of the United States or as the result of the disposition of stock or obligations of a corporation in which the taxpayer owned at least 10 percent of the voting stock.

The amendment requires the Secretary of the Treasury or his delegate by regulations to prescribe the manner of applying foreign tax credit carrybacks and carryovers where the taxpayer elects the overall limitation as to other income and provides transitional rules (1) for foreign tax credit carrybacks from years to which the new provisions apply to years to which they do not apply, and (2) for foreign tax credit carryovers from years to which the new provisions do not apply to years to which they do apply. The new provisions are to apply with respect to taxable years beginning after the date of the enactment of the bill, but only with respect to interest resulting from transactions consummated after April 2, 1962. The House recedes.

EARNED INCOME FROM SOURCES WITHOUT THE UNITED STATES

Amendment No. 123: This amendment adds a new paragraph (6) to section 911(c) of the code as contained in the bill as passed by the House. Section 911(c) contains special rules for determining the amount of earned income from sources without the United States which is excludable from gross income. The new paragraph (6) provides that a statement by an individual who has earned income from sources within a foreign country to the authorities of that country that he is not a resident of that country, if he is held not subject as a resident of that country to the income tax of that country by its authorities with respect to such earnings, shall be conclusive evidence with respect to such earnings that he is not a bona fide resident of that country for purposes of section 911(a)(1). The House recedes.

Amendment No. 124: This amendment adds a new paragraph (7) to section 911(c) of the code as contained in the bill as passed by the

House. Under the new paragraph (7), if an individual who qualifies as a bona fide resident of a foreign country receives compensation from sources without the United States (except from the United States or any agency thereof) in the form of the right to use property or facilities, the $20,000 or $35,000 limitation applicable with respect to such individual (A) for a taxable year ending in 1963, is to be increased by an amount equal to the amount of such compensation so received during such taxable year; (B) for a taxable year ending in 1964, is to be increased by an amount equal to two-thirds of such compensation so received during such taxable year; and (C) for a taxable year ending in 1965, is to be increased by an amount equal to one-third of such compensation so received during such taxable year. The House recedes.

Amendment No. 125: The bill as passed by the House provided that the amendment made to section 911 of the code was to apply to taxable years ending after December 31, 1962, but only with respect to amounts received after December 31, 1962, which were attributable either to (A) services performed after December 31, 1962, or (B) services performed on or before December 31, 1962, but only if on March 12, 1962, there existed no right (whether forfeitable or nonforfeitable) to receive such amounts. Senate amendment No. 125 provides that the amendment made to section 911 of the code will apply to taxable years ending after September 4, 1962, but only with respect to (1) amounts received after March 12, 1962, which are attributable to services performed after December 31, 1962, or (2) amounts received after December 31, 1962, which are attributable to services performed on or before December 31, 1962, unless on March 12, 1962, there existed a right (whether forfeitable or nonforfeitable) to receive such amounts. The House recedes.

CONTROLLED FOREIGN CORPORATIONS

Amendment No. 126: The bill as passed by the House added a new subpart F to part III of subchapter N of chapter 1 of the code (relating to income from sources without the United States). The new subpart F (relating to controlled foreign corporations) provided rules under which a United States person who owns stock in a controlled foreign corporation would be required to include in his gross income a pro rata share of certain portions of the controlled foreign corporation's income. Senate amendment No. 126 struck out these provisions of the bill as passed by the House and inserted new text in the nature of a substitute which adds a new subpart F (relating to controlled foreign corporations) and a new subpart G (relating to export trade corporations). Under the conference agreement, the House recedes with amendments, which, except as discussed below in paragraph (m) relating to receipt of minimum distributions, are either technical or clerical. The more important differences between the bill as passed by the House and the Senate amendment as agreed to in conference are explained below.

(a) *Amounts included in gross income.*—The bill as passed by both the House and the Senate provides, in general, that a U.S. person who owns, or is considered to own, 10 percent or more of the total combined voting power of all classes of stock entitled to vote of a controlled foreign corporation is required to include in his gross income his pro rata share of (1) the subpart F income of the foreign corporation, (2)

previously excluded subpart F income withdrawn from investment in less developed countries, and (3) the increase in earnings of the foreign corporation invested in certain property ("nonqualified property" in the bill as passed by the House, and limited to "United States property" in the Senate amendment). Under the bill as passed by the House, this provision applied if the foreign corporation was a controlled foreign corporation on any one day of the taxable year. Senate amendment No. 126 requires that the foreign corporation be a controlled foreign corporation for an uninterrupted period of 30 days or more during its taxable year. The bill as passed by both the House and the Senate defines U.S. persons to mean, in general, citizens or residents of the United States, domestic partnerships and corporations, and any estate or trust (other than a foreign estate or trust). However, Senate amendment No. 126, in cases relating to certain corporations organized in the Commonwealth of Puerto Rico or possessions of the United States, excludes from the definition of U.S. persons certain individual citizens of the United States who are bona fide residents in the Commonwealth of Puerto Rico or the possession of the United States in which the corporation is created or organized.

(b) *Subpart F income.*—

(1) *Amounts included.*—The bill as passed by both the House and the Senate included within the term "subpart F income" the foreign base company income of a controlled foreign corporation and the income of a controlled foreign corporation derived from the insurance of U.S. risks. The bill as passed by the House also included in the subpart F income of a controlled foreign corporation income of such corporation derived from U.S. patents, copyrights, and exclusive formulas and processes if such properties were substantially developed, created, or produced in the United States or were acquired from a related U.S. person. Senate amendment No. 126 does not include such income in subpart F income. However, see amendment No. 161 for a provision that gain on the sale or exchange of such property to a foreign corporation controlled by the transferor is to be taxable as ordinary income.

(2) *Limitations on subpart F income.*—The bill as passed by both the House and Senate provided that the subpart F income of a controlled foreign corporation could not exceed the earnings and profits for the taxable year. Senate amendment No. 126 provides that, for purposes of this limitation, the earnings and profits for any taxable year is to be reduced by deficits in earnings and profits for taxable years of the controlled foreign corporation beginning after December 31, 1962 (and certain deficits in earnings and profits for taxable years beginning after December 31, 1959, and before January 1, 1963) and, under regulations prescribed by the Secretary of the Treasury or his delegate, by deficits in earnings and profits of other corporations in a chain of ownership which includes the controlled foreign corporation.

(c) *Income derived from insurance of U.S. risks.*—The bill as passed by both the House and the Senate provides that subpart F income includes income of a controlled foreign corporation derived from the insurance or reinsurance of property in the United States or of lives or health of residents of the United States. However, under Senate amendment No. 126 this provision applies only if the premiums or other consideration received or accrued in respect of such insurance or reinsurance by a controlled foreign corporation represents more than 5 percent of total premiums and other consideration.

(d) *Foreign base company income.*—The bill as passed by both the House and the Senate provides that the term "foreign base company income" means the sum of the foreign personal holding company income (discussed in paragraph (e) below) and the foreign base company sales income (discussed in paragraph (f) below) of a controlled foreign corporation. Senate amendment No. 126 also includes foreign base company services income (discussed in paragraph (g) below) within the defined term.

(e) *Foreign personal holding company income.*—The bill as passed by both the House and the Senate provides that subpart F income of a foreign corporation includes foreign personal holding company income, with certain modifications. The bill as passed by the House provided for an exclusion in the case of personal holding company income of certain banks. The Senate amendment provides for an exclusion from personal holding company income of: (i) rents and royalties derived from the active conduct of a trade or business, if received from an unrelated person; (ii) dividends, interest, and certain gains derived in the conduct of a banking, financing, or similar business, or derived by an insurance company on investments of unearned premiums or certain reserves, if received from an unrelated person; (iii) dividends and interest received from related persons if such persons are organized, and have a substantial part of their assets, within the country of incorporation of the controlled foreign corporation; (iv) interest received in the conduct of a banking, financing, or similar business from a related person also engaged in the conduct of a banking, financing, or similar business, if the businesses of both the recipient and payor are predominantly with unrelated persons; and (v) rents, royalties, and similar amounts received from a related person for the use of, or the privilege of using, property within the country of incorporation of the controlled foreign corporation.

(f) *Foreign base company sales income.*—The bill as passed by both the House and the Senate provides that subpart F income of a controlled foreign corporation includes income, whether in the form of profits, commissions, fees, or otherwise, derived by a controlled foreign corporation in connection with the purchase of property from a related person, or sale of property to a related person, when the property sold was neither manufactured in, nor sold for use, consumption, or disposition in, the country in which the controlled foreign corporation is organized. The Senate amendment provides that foreign branches of a controlled foreign corporation shall, under certain circumstances, be treated as wholly owned subsidiary corporations for purposes of determining the foreign base company sales income of the controlled foreign corporation, and treats foreign base company sales income of the branch as foreign base company sales income of the controlled foreign corporation.

The bill as passed by the House provided for a reduction of foreign base company sales income by an amount equal to the increase in qualified investments in less developed countries. Moreover, the bill as passed by the House provided that foreign base company sales income would be includible in subpart F income only if such income amounted to at least 20 percent of gross income (not including other foreign base company income). Senate amendment No. 126 contains neither provision. However, see the discussion below under paragraph (h) relating to exclusions from foreign base company income.

(g) *Foreign base company services income.*—Senate amendment No. 126 provides that subpart F income of a controlled foreign corporation includes income, whether in the form of compensation, commissions, fees, or otherwise, derived by a controlled foreign corporation in connection with the performance of technical, managerial, engineering, or like services if such services are performed for a related person and are performed outside the country of incorporation of the controlled foreign corporation, and if such income is not related to certain selling activities. The bill as passed by the House did not contain any similar provision.

(h) *Exclusions from foreign base company income.*—The bill as passed by the House provided that no part of the gross income of a controlled foreign corporation would be treated as foreign base company income if such income was less than 20 percent of gross income, and that the entire gross income of such a corporation would be treated as foreign base company income if such income exceeded 80 percent of gross income. Senate amendment No. 126 changes these percentages to 30 percent and 70 percent, respectively. The bill as passed by the House also provided, in general, that foreign base company income was to be reduced by an amount equal to the increased investment in certain less developed country properties, including stock of a foreign corporation engaged in business almost wholly within less developed countries if substantially all the property of such corporation was ordinary and necessary for the active conduct of such trade or business. Senate amendment No. 126 provides that foreign base company income does not include dividends and interest received from qualified investments in less developed countries, and net gain from the sale or exchange of such investments to the extent such dividends, interest, and gains do not exceed the increased investment of a controlled foreign corporation, for the taxable year, in qualified investments in less developed countries. The Senate amendment also provides that foreign base company income does not include income of a controlled foreign corporation derived from the use of any aircraft or vessel in foreign commerce, or from services directly related to such use.

(i) *Withdrawal of previously excluded subpart F income from qualified investments.*—As noted in paragraph (h) above, Senate amendment No. 126 provides that dividends, interest, and gains derived from qualified investments in less developed countries are excluded from foreign base company income to the extent of the increased investment for the taxable year, in qualified investments in less developed countries. Amounts once excluded from foreign base company income under this provision are, however, included in gross income of U.S. shareholders when there is a decrease in qualified investments in less developed countries.

(1) *Qualified investments in less developed countries.*—The Senate amendment defines the term "qualified investments in less developed countries" to mean (A) stock of a less developed country corporation, but only if the controlled foreign corporation which makes the investment owns 10 percent or more of the stock of such corporation, (B) an obligation of a less developed country corporation which at the time acquired by the controlled foreign corporation has a maturity of 1 year or more, but only if the controlled foreign corporation which makes the investment owns 10 percent or more of the stock of such corporation, and (C) obligations of a less developed country. How-

ever, if any such investment is disposed of within 6 months after the date of its acquisition, it is not to be treated as a qualified investment.

(2) *Less developed country corporations.*—Senate amendment No. 126 defines the term "less developed country corporation" to mean a foreign corporation engaged in the active conduct of a trade or business if (A) such corporation derives 80 percent or more of its gross income from sources within less developed countries, and (B) 80 percent or more of the assets of such corporation consists of (i) property located in less developed countries if used in an active trade or business, (ii) stock of any other less developed country corporation, (iii) obligations of less developed country corporations which at the time of their acquisition have a maturity of 1 year or more, (iv) obligations of a less developed country, and (v) certain other investments, including certain permissible investments in the United States. The Senate amendment also provides that the term "less developed country corporation" includes a foreign corporation (1) which, in general, derives 80 percent or more of its gross income (A) from the use in foreign commerce of aircraft or vessels registered under the laws of a less developed country, (B) from the performance of services directly related to such aircraft or vessels, (C) from the sale or exchange of such aircraft or vessels, and (D) from dividends and interest received from other less developed country corporations (within the meaning of this sentence) in which the recipient owns 10 percent or more of the voting stock, and from gain from the sale or exchange of stock or obligations of such other less developed country corporations, and (2) 80 percent or more of the assets of which consists of assets used in connection with the production of income described in (1) above, and of certain permissible investments in the United States.

(j) *Increase in investments in certain property.*—The bill as passed by the House provided for the inclusion in gross income of U.S. shareholders of earnings and profits of a controlled foreign corporation invested in nonqualified property to the extent of a shareholder's pro rata share of the increase in such investments for the taxable year. As defined in the bill as passed by the House, nonqualified property meant (1) property located in the United States, with certain exceptions, but including stock in a domestic corporation or an obligation of a U.S. person, and (2) property other than property ordinary and necessary for the active conduct of a trade or business (or for a substantially similar trade or business) carried on by the controlled foreign corporation outside the United States, if (A) the business had been carried on since December 31, 1962, or for a 5-year period ending at the close of the preceding taxable year, or (B) the business was carried on almost wholly within less developed countries. Senate amendment No. 126 includes only the first category of nonqualified property defined in the Senate amendment as "United States property".

(k) *Controlled foreign corporations.*—The bill as passed by the House provided that a foreign corporation would be considered a controlled foreign corporation if more than 50 percent of the total combined voting power of all classes of its stock entitled to vote was owned by U.S. persons on any day during the taxable year of such corporation. Under Senate amendment No. 126, a foreign corporation is a controlled foreign corporation only if U.S. shareholders (defined as a U.S. person who owns, with the application of special rules of ownership continued in the Senate amendment, 10 percent or more of the stock

of a foreign corporation) on any day during the taxable year of such corporation owned more than 50 percent of the total combined voting power of all classes of stock entitled to vote of such corporation. Senate amendment No. 126 also provides that a corporation organized in the Commonwealth of Puerto Rico or a possession of the United States is excluded from the term "controlled foreign corporation" if the corporation is primarily engaged in the active conduct of specified trades or businesses in the Commonwealth of Puerto Rico or a possession of the United States and derives its income from specified sources.

(l) *Individuals subject to tax at corporate rates.*—Senate amendment No. 126 provides that a U.S. shareholder who is an individual may elect to limit his U.S. tax liability with respect to amounts which are includible in his gross income under the new subpart F by using the rates provided by section 11 of the code applicable in the case of a domestic corporation, and by applying the provisions of section 960 (relating to foreign tax credit). A U.S. shareholder who makes an election under this provision must, in the year of actual distribution of an amount previously taxed under subpart F, include an amount in gross income equal to the amount distributed reduced by U.S. tax previously paid with respect to such amount.

(m) *Receipt of minimum distributions.*—Senate amendment No. 126 provides that if a given percentage of the earnings and profits of a controlled foreign corporation is distributed, a domestic corporate shareholder may elect to exclude from its gross income its share of the amount of subpart F income of such controlled foreign corporation. A domestic corporate shareholder may elect to apply the minimum distribution provision on the basis of (1) any controlled foreign corporation in which it owns stock directly, (2) controlled foreign corporations in a chain of ownership, or (3) all controlled foreign corporations. In the case of an election with respect to all controlled foreign corporations, the domestic corporation may also elect (A) to exclude, under certain circumstances, less developed country corporations, and (B) to treat its foreign branches as controlled foreign corporations, for purposes of this provision. The required minimum distribution decreases as the effective foreign tax rate increases, with the result that the sum of the amount of foreign tax paid by the foreign corporations, and the U.S. tax paid by the shareholders on distributions of current earnings and profits of such corporations, produces an overall effective tax on current foreign profits equal to approximately 90 percent of the tax that would have been paid had the foreign corporations been taxable as domestic corporations. Under the conference agreement, a new table of minimum distributions, which permits less variation from this 90-percent requirement, is substituted for the table contained in Senate amendment No. 126. Under Senate amendment No. 126, an affiliated group of corporations eligible to file a consolidated return under section 1501 of the code could elect to be treated as a single corporation for purposes of applying the minimum distribution provision. Under the conference agreement, this election may be made only if the affiliated group actually files such a consolidated return for the taxable year.

(n) *Export trade corporations.*—Senate amendment No. 126, which adds a new subpart G to part III of subchapter N of chapter 1 of the code, provides that the subpart F income of a controlled foreign corporation which is an export trade corporation shall be reduced by the export trade income of such corporation which constitutes foreign

base company income. In general, this provision applies to controlled foreign corporations which derive more than 75 percent of their gross income from (1) the sale of property produced in the United States to unrelated persons for use outside the United States, (2) the performance of certain services outside the United States for unrelated persons, (3) the use of export property by unrelated persons, and (4) the receipt of interest on obligations which qualify as export trade assets. However, the amount of export trade income which reduces subpart F income is limited to the lesser of (1) an amount equal to 1½ times certain export promotion expenses of the controlled foreign corporation, or (2) an amount equal to 10 percent of the gross receipts of such corporation from the transactions described above. In addition, the amount of export trade income which reduces subpart F income can in no event exceed an overall limitation based on the increase in investments in export trade assets.

(o) *Miscellaneous.*—The committee of conference was informed by the Treasury Department of the policy it plans to follow in the granting of rulings under section 367 of the Internal Revenue Code of 1954 in situations in which taxpayers seek to reorganize, during a reasonable period after the enactment of the bill, their foreign corporate structures in response to the enactment of section 12 of the bill as agreed to in conference.

The Treasury Department, for purposes of section 367, will not treat a transaction involving the reorganization of foreign corporate structures as being in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes solely by reason of the fact that a principal purpose of the reorganization is to terminate a method of operation which would result in tax to U.S. shareholders under the provisions of section 12 of the bill. In such cases a favorable ruling under section 367 will generally not be denied by the Treasury Department in transactions in which earnings and profits of foreign corporations are carried over to other foreign corporations under circumstances in which there will be no reduction of the U.S. taxes (and foreign taxes) that would be payable on the eventual remittance of such earnings and profits to U.S. shareholders.

Under present administrative rules, where corporate shareholders are involved the Treasury Department generally does not issue rulings under section 367 which permit the tax-free remittance to the United States of earnings and profits of foreign corporations. However, under existing practice a ruling permitting a tax-free exchange is generally given subject to a condition that an appropriate amount be included in the income of the domestic shareholder (thus negating the existence of a principal purpose to avoid U.S. tax). Such rulings will continue to be given even though a principal purpose of the transaction is (1) to terminate the activities of a foreign corporation which would result in tax to U.S. shareholders under the provisions of section 12 of the bill, and (2) to carry on such activities in the future through a domestic corporation.

The conferees recognize that the problems in this area are complex and that particular aspects of the policy as explained above may require qualification and refinement as experience is gained in applying it to particular situations.

The conferees on the part of the Senate called attention to the colloquy in the Senate with respect to the amendment offered in the Senate relating to corporations engaged in producing or selling books

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or other media of communications, etc. (see pp. 17511–17513 of the daily Congressional Record for Sept. 5, 1962). The conferees were advised that the substance of this amendment was not within the jurisdiction of the conference committee. However, the conferees have requested the Treasury Department to study this matter and report back next year to the Committees on Ways and Means and Finance.

GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE PROPERTY

Amendments Nos. 128, 129, 130, and 131: The bill as passed by both the House and the Senate adds a new section 1245 to the code. In general, the new section provides for the treatment as ordinary income of the gain from the disposition of certain depreciable property to the extent of depreciation deductions (taken in periods specified in the bill) which are reflected in the adjusted basis of the property.

Under the bill as passed by the House, the new section 1245 applied to property disposed of after the date of the enactment of the bill and to the extent of adjustments for depreciation and certain amortization for taxable years beginning after December 31, 1961. Under Senate amendment No. 128, the new section applies to property disposed of during a taxable year beginning after December 31, 1962. Under Senate amendments Nos. 129, 130, and 131, the adjustments taken into account are those attributable to periods after December 31, 1961. The House recedes.

Amendment No. 132: The bill as passed by both the House and the Senate amends section 167 of the code to permit a taxpayer to elect to change his method of depreciation in respect of section 1245 property from any declining balance or sum of the years-digits method to the straight line method. Under the bill as passed by the House, the election was required to be made within the period after the date of the enactment of the bill prescribed by the Secretary of the Treasury or his delegate. Under Senate amendment No. 132, the election must be made by the taxpayer on or before the last day prescribed by law (including extensions thereof) for filing his return for his first taxable year beginning after December 31, 1962. The House recedes.

Amendment No. 133: This amendment adds a new provision to the bill inserting a new sentence after the second sentence of section 613(a) of the code, relating to the general rule for computing percentage depletion. The new sentence, which does not affect the computation of the gross income from the property under the first sentence of section 613(a), provides that the allowable deductions taken into account with respect to expenses of mining in computing the taxable income from the property shall, for purposes of the 50-percent limitation contained in the second sentence of section 613(a), be decreased by an amount equal to so much of any gain which (1) is treated under new section 1245 of the code (relating to gain from disposition of certain depreciable property) as ordinary income, and (2) is properly allocable to the property. The House recedes.

Amendment No. 135: Under the bill as passed by the House, the amendments made by the bill relating to gain from dispositions of certain depreciable property (new sec. 1245), including the election to change the method of depreciation with respect to section 1245 property, the amount taken into account as salvage value, and the special rule for charitable contributions of section 1245 property, were to apply to taxable years beginning after December 31, 1961,

and ending after the date of the enactment of the bill. Under Senate amendment No. 135, the amendments (except the amendments with respect to salvage value, which take effect as provided by the bill as passed by the House) are to apply to taxable years beginning after December 31, 1962. The House recedes.

FOREIGN INVESTMENT COMPANIES

Amendments Nos. 140 and 141: The bill as passed by both the House and the Senate adds a new section 1246 to the code, relating to gain on foreign investment company stock.

Under the bill as passed by the House, a foreign investment company was defined as any foreign corporation which met one of two alternative tests. Under Senate amendment No. 140, either of these two tests must be met for any taxable year beginning after December 31, 1962. One test is registration under the Investment Company Act of 1940 either as a management company or as a unit investment trust. The second test (which must be met at a time when more than 50 percent of either the voting power or total value of the stock is held by U.S. persons) under the House bill was that the foreign corporation must be engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities (within the meaning of section 3(a)(1) of the Investment Company Act of 1940). Senate amendment No. 141, in effect, excludes from the second test certain foreign corporations such as brokers, banks, and small loan companies. The House recedes on Senate amendments Nos. 140 and 141.

Amendment No. 143: Subsection (e)(1) of section 1246 added to the code by the bill provides that the basis of stock of a foreign investment company acquired from a decedent dying after December 31, 1962, is to be reduced by the amount of the decedent's ratable share of earnings and profits. Under the bill as passed by the House, the ratable share was of the accumulated earnings and profits of the company. Under Senate amendment No. 143, the ratable share is of the earnings and profits accumulated after December 31, 1962. The House recedes.

Amendment No. 145: This amendment adds a new subsection (g) to the new section 1246 of the code. The new subsection (g) provides that if a registered foreign investment company has made an election (under the new sec. 1247 added by the bill) to distribute income currently with respect to taxable years beginning after December 31, 1962, then section 367 of the code is not to apply in respect of such foreign investment company if the company is a party to a reorganization in which all of its properties are acquired before January 1, 1964, by a domestic corporation which is a regulated investment company under section 851 for its first taxable year ending after the reorganization. The committee of conference was informed by the Treasury Department that the proposed new subsection was not needed in view of the administrative practices under section 367 of the code, and might therefore imply that such practices are erroneous. The Senate recedes.

Amendment No. 147: New section 1247 added to the code by the bill provides that new section 1246 of the code (treating gain on sale or exchange of foreign investment company stock as ordinary income) is not to apply to the qualified shareholders of a registered foreign investment company if the company elects on or before December

31, 1962, with respect to each taxable year beginning after such date, to distribute 90 percent or more of its taxable income currently and to designate in a written notice to its shareholders the pro rata amount of the excess of the net long-term capital gain over the net short-term capital loss and the portion thereof which is being distributed. Under the bill as passed by the House, the notice must be mailed before the expiration of 30 days after the close of the taxable year. Under Senate amendment No. 147, the notice must be mailed before the expiration of 45 days after the close of the taxable year. The House recedes.

Amendment No. 153: This amendment strikes out subsection (d) of the new section 1247 added to the code by the bill and inserts subsections (d), (e), (f), and (g).

Under the Senate amendment the new subsection (d) requires each qualified shareholder of a foreign investment company with respect to which an election under section 1247 is in effect to compute his long-term capital gains by including his pro rata share of the distributed portion of the company's excess of net long-term capital gain over net short-term capital loss and his pro rata share of the undistributed portion of such excess. Subsection (e) is the same as subsection (d) as passed by the House in requiring proper adjustment in the earnings and profits of the company and in the adjusted basis of stock of such company held by such shareholder to reflect such shareholder's inclusion in gross income of undistributed capital gains, but also requires proper adjustment in a qualified shareholder's ratable share of the company's earnings and profits.

Subsections (f), (g), and (h) are new provisions relating to the election by a foreign investment company with respect to foreign taxes. Under subsection (f), a foreign investment company which has elected to distribute income currently and more than 50 percent of the value of whose total assets at the close of the taxable year consists of stock or securities in foreign corporations may elect (for such taxable year and for purposes of complying with its election to distribute 90 percent or more of its taxable income) to compute its taxable income without any deduction for income, etc., taxes paid to foreign countries or possessions of the United States and to treat the amount of such taxes as distributed to its shareholders. If the election is made each qualified shareholder of the company is required (1) to include in gross income and treat as paid by him his proportionate share of such taxes, and (2) for purposes of the foreign tax credit, to treat such share of taxes as having been paid to the country in which the company is incorporated and to treat as gross income from sources within such country such share of taxes and any dividend paid to him by the company. Subsection (g) provides for notice to the shareholders of their proportionate share of the taxes to be taken into account as provided in subsection (f). Subsection (h) provides that the election and notice are to be made in such manner as the Secretary of the Treasury or his delegate may prescribe by regulations. The House recedes.

GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS

Amendments Nos. 159 and 160: The bill as passed by the House added a new section 1248 to the code which provided, in general, that (1) if a U.S. person owned, or was considered to have owned, 10 per-

cent or more of the voting stock of a foreign corporation on the date he sells or exchanges stock in such corporation, or during the 5-year period ending on such date, and (2) the foreign corporation was a controlled foreign corporation on the date of the sale or exchange or during the 5-year period ending on such date, then (1) gain recognized on the sale or exchange, other than in redemption or liquidation of such stock, would, to the extent of the earnings and profits of the corporation attributable to the stock sold or exchanged, be considered gain from the sale of property which is not a capital asset, and (2) gain recognized on a distribution in redemption or liquidation of such corporation would, to the extent of the earnings and profits of the corporation attributable to the stock exchanged, be treated as a dividend. The new section 1248 provided for the reduction in the earnings and profits of a foreign corporation by amounts included in gross income of a U.S. person as subpart F income or as amounts invested in nonqualified property, but only to the extent such amounts did not result in an exclusion from gross income. The bill did not apply to distributions in redemption of stock to pay death taxes, consideration received in an exchange to which section 356 applied, or to amounts includible in gross income under any other provision of the code as a dividend, gain from the sale of an asset which is not a capital asset, or gain from the sale of an asset held for not more than 6 months.

Senate amendment No. 159 provides that (*a*) if a U.S. person sells or exchanges stock in a foreign corporation (including distributions in redemption or liquidation), and (*b*) such person owns, or is considered to own, 10 percent or more of the voting stock of such corporation at any time during the 5-year period ending on the date of sale or exchange on a date when such corporation was a controlled foreign corporation, then the gain shall be includible in the gross income of such U.S. person as a dividend, to the extent of the earnings and profits of the foreign corporation accumulated (1) in taxable years of the corporation beginning after December 31, 1962, (2) while the stock sold or exchanged was held by the U.S. person, and (3) while the foreign corporation was a controlled foreign corporation.

Senate amendment No. 159 provides that earnings and profits of a foreign corporation are to be determined according to rules substantially similar to those applicable to domestic corporations, except that the earnings and profits are to be reduced with respect to a U.S. person by amounts included in gross income under section 951, gain realized from the sale or exchange of property in pursuance of a plan of complete liquidation, income derived from sources within the United States of a foreign corporation engaged in trade or business within the United States, amounts included in gross income of a qualified shareholder of a foreign investment company, and, in some cases, by earnings and profits accumulated while the foreign corporation was a less developed country corporation.

Under Senate amendment No. 159, the earnings and profits of a foreign corporation whose stock is sold or exchanged is, under certain circumstances, deemed to include earnings and profits of foreign corporations in a chain of corporations. The Senate amendment also provides that if a domestic corporation was formed or availed of principally for the holding, directly or indirectly, of stock of one or more foreign corporations, the sale or exchange of the stock of the domestic corporation will be treated as a sale or exchange of the stock of the foreign corporation or corporations held by the domestic corporation.

The new section 1248, as amended by Senate amendment No. 159, provides a limitation on the tax imposed on an individual who is a U.S. person by reason of the application of the new section. In general, the tax so imposed is not to exceed the greater of (1) his pro rata share of the taxes which would have been imposed if the foreign corporation had been a domestic corporation during the period he held the stock sold or exchanged, or (2) the taxes which would have been imposed if the amounts to which the section applies had been received as dividends in the years in which earned by the foreign corporation. With respect to Senate amendment No. 159, the House recedes with amendments which (1) eliminate the second limitation described in the preceding sentence, and (2) make clerical and conforming changes.

Under the bill as passed by the House, the new section 1248 applied to sales or exchanges after the date of the enactment of the bill. Senate amendment No. 160 provides that the new section shall apply to sales or exchanges after December 31, 1962. The House recedes.

SALES AND EXCHANGES OF PATENTS, ETC., TO CERTAIN FOREIGN CORPORATIONS

Amendment No. 161: Senate amendment No. 161 adds a new section to the bill which adds a new section 1249 to the code, relating to gain of a U.S. person from the sale or exchange after December 31, 1962, of a patent, invention, model, or design (whether or not patented), copyright, secret formula or process, or similar property right to a foreign corporation which such person controls (within the meaning of the new sec. 1249). If such gain would (but for the new section) be gain from the sale or exchange of a capital asset or of property described in section 1231, then such gain is to be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231. Under subsection (c) of the new section 1249, the new section would not apply, however, to gain realized from the sale or exchange for stock or contribution to capital of such property where it is established to the satisfaction of the Secretary of the Treasury or his delegate that the principal purpose of the transfer is to enable the foreign corporation to use the property in its own manufacturing operations. The new section 1249 applies to taxable years beginning after December 31, 1962.

Under the conference agreement, the House recedes with an amendment striking out subsection (c) of the new section 1249. With the deletion of subsection (c), the new section 1249 provides ordinary income treatment for all taxable sales or exchanges of patents (and other property covered by the provision) by a domestic corporation to a foreign corporation which it controls. The new section 1249 would not apply to nontaxable transactions such as those sales or exchanges to which (as the result of a ruling under sec. 367) section 351 of the code applies. Neither the enactment of section 1249 nor the deletion of the exception in subsection (c) is intended to have any implications with respect to the application of section 367 of the code to such nontaxable transactions.

The conferees requested the Treasury Department to study and report back on the proper tax treatment of the transfer of patents, etc., to foreign subsidiaries which use such property in their own manufacturing operations.

TAX TREATMENT OF COOPERATIVES AND PATRONS

Amendments Nos. 162, 163, 166, 167, and 168: The bill as passed by the House provides that, in computing the taxable income of a cooperative organization, certain distributions paid to patrons in the form of qualified written notices of allocation are to be treated as deductions from the cooperative's gross income. The recipients of such qualified written notices of allocation are required to include the stated dollar amount of such allocations in their gross income when received. A written notice of allocation is qualified only if (1) it is payable in cash within 90 days at the option of the patron, or (2) the patron has consented to include the stated dollar amount of this written notice of allocation in his gross income. Senate amendment No. 163 contains a further requirement which provides that a written notice of allocation is not a qualified one unless 20 percent or more of the distribution of which it is a part is paid in money or by qualified check.

The bill as passed by the House provides two methods by which a patron may consent to the inclusion in his gross income of the stated dollar amount of qualified written notices of allocation not redeemable in cash within the period provided in the bill. Senate amendments Nos. 162 and 166 provide a third method by which such consent may be made. Under this third method a patron may consent by endorsing and cashing (within the time prescribed by the amendment) a qualified check which is paid as a part of the same distribution as the written notice of allocation. Under Senate amendment No. 167, a qualified check is defined as a check (or other instrument redeemable in money) on which there is a clearly imprinted statement that the endorsement and cashing of the check (or other instrument) constitutes the consent of the payee to include in his gross income, as provided in the Federal income tax laws, the stated dollar amount of the written notice of allocation which is a part of the patronage dividend or payment of which such qualified check is also a part. Under Senate amendment No. 168, if a qualified check is not cashed on or before the 90th day after the close of the payment period for the taxable year with respect to which it is paid, such check becomes a nonqualified written notice of allocation. The House recedes on amendments Nos. 162, 163, 166, 167, and 168.

WITHHOLDING OF INCOME TAX AT SOURCE ON INTEREST, DIVIDENDS, AND PATRONAGE DIVIDENDS; REPORTING OF INTEREST, DIVIDEND, AND PATRONAGE DIVIDEND PAYMENTS OF $10 OR MORE DURING A YEAR

Amendment No. 173: Section 19 of the bill as passed by the House added to the Internal Revenue Code of 1954 provisions requiring the withholding of income tax at source on certain interest, dividend, and patronage dividend payments. The tax was to be withheld at the rate of 20 percent and was to apply to payments of interest, dividends, and patronage dividends as those terms were defined for withholding purposes. In addition, the bill as passed by the House provided for exemptions from withholding, quarterly refunds, and special credits. The tax withheld was to be allowed as a credit against the income tax of the recipients of the payments to the extent it had not been previously refunded to them or credited against other tax due from them.

Amendment No. 173 strikes out the provisions of section 19 of the bill as passed by the House and, in lieu thereof, adds to the Internal

Revenue Code of 1954 provisions requiring persons who make payments of dividends, patronage dividends, or interest (within the meaning of such terms as defined in the Senate amendment) aggregating $10 or more to any other person in a calendar year to file an information return with the Secretary of the Treasury or his delegate with respect to such payments. The Senate amendment adds provisions requiring that payors of dividends, patronage dividends, and interest (as those terms are defined by the amendment) furnish to the recipients of these amounts annual statements showing the amounts paid to them as reported on the information returns filed with the Internal Revenue Service. New penalty provisions are provided by the Senate amendment for failure to file information returns with respect to payments of dividends, patronage dividends, or interest, and for failure to furnish to a recipient of such payments an annual statement of such payments.

The House recedes with clerical amendments. As a part of the agreement to the Senate amendment, the House and Senate conferees have requested the Treasury Department to make annual reports to the Committees on Ways and Means and Finance on the improvement in the reporting on tax returns of dividends, interest, and patronage dividends as a result of the Senate amendment, with the view that this matter will be reconsidered by the Committees on Ways and Means and Finance if it is determined that there has not been sufficient improvement in the reporting of such income.

INFORMATION WITH RESPECT TO CERTAIN FOREIGN ENTITIES

Amendment No. 176: Section 6038(b) of the code, as contained in the bill as passed by both the House and the Senate, provides for a reduction in foreign tax credit for each failure to furnish information with respect to a foreign corporation controlled by a U.S. person. Senate amendment No. 176 provides that such reduction is not to exceed whichever of the following amounts is greater: (A) $10,000, or (B) the income of the foreign corporation for its annual accounting period with respect to which the failure occurs. The House recedes.

Amendment No. 179: Section 6038(d)(1) of the code as contained in the bill as passed by the House provided that, in applying the constructive ownership rules of section 318(a) of the code for purposes of determining control under section 6038 of the code, the rule which requires ownership of 50 percent of the stock of a corporation before stock owned by such corporation is attributed to its stockholders was to apply without regard to the 50-percent limitation. Senate amendment No. 179 substitutes a 10-percent limitation for the 50-percent limitation. Senate amendment No. 179 also provides that the rules of section 318(a)(2) of the code that stock owned by a partner or a beneficiary of an estate or trust will be considered as owned by the partnership, estate, or trust, are not to be applied so as to consider a U.S. person as owning stock which is owned by a person who is not a U.S. person, nor will a corporation be considered as owning stock owned by or for a 50 percent or more stockholder where the effect is to consider a U.S. person as owning stock which is owned by a person who is not a U.S. person. The House recedes.

Amendments Nos. 180 and 181: Section 6046 (a) and (b) of the code, as amended by the bill as passed by the House, required each U.S. citizen or resident who (on or after January 1, 1963) was or becomes an officer or director of a foreign corporation and each U.S. person who (on or after January 1, 1963) was or becomes an owner of 5 per-

cent or more in value of the stock of such a corporation to file an information return setting forth such information as the Secretary of the Treasury or his delegate prescribes by forms or regulations as necessary for carrying out the provisions of the income tax laws. Under Senate amendment No. 180, such an officer or director is required to file an information return only if 5 percent or more in value of the stock of the foreign corporation is owned by a U.S. person. Under Senate amendment No. 181, in the case of an officer or director of the foreign corporation, the information required is limited to furnishing the names and addresses of the U.S. persons who own 5 percent or more in value of the stock of such corporation. The House recedes on amendment No. 180 with a technical amendment. The House recedes on amendment No. 181.

Amendment No. 183: This amendment adds a new subsection (e) to section 6046 of the code. Under the new subsection, no information is to be required to be furnished under section 6046 with respect to any foreign corporation (1) if the liability of the U.S. citizen, resident, or person to file a return under section 6046(a) arises on or after January 1, 1963, and before March 1, 1963, unless such information is required to be furnished under regulations which have been in effect since January 1, 1963 (but only if such regulations were prescribed before December 1, 1962), or (2) if the liability of the U.S. citizen, resident, or person to file a return under section 6046(a) arises on or after March 1, 1963, unless such information is required to be furnished under regulations which have been in effect for at least 90 days.

Under the conference agreement, the House recedes with an amendment substituting a new subsection (e). Under the conference agreement, in the case of liability to file a return under section 6046 of the code arising on or after January 1, 1963, and before June 1, 1963—

(A) no information is to be required to be furnished under section 6046 with respect to any foreign corporation unless such information was required to be furnished under regulations in effect on or before March 1, 1963, and

(B) if the date on which such regulations become effective is later than the day on which such liability arises, any return required by section 6046(a) is required (in lieu of the time prescribed by sec. 6046(d)) to be filed on or before the 90th day after such date.

In the case of liability to file a return under section 6046(a) arising on or after June 1, 1963, no information is to be required to be furnished under section 6046 with respect to any foreign corporation unless such information was required to be furnished under regulations which have been in effect for at least 90 days before the date on which the U.S. citizen, resident, or person becomes liable to file a return required under section 6046(a).

EXPENDITURES BY FARMERS FOR CLEARING LAND

Amendment No. 189: This amendment adds a new section to the bill, adding a new section 182 to part VI of subchapter B of chapter 1 of the code (relating to itemized deductions for individuals and corporations). The new section 182 permits farmers to elect to treat as deductible expenses, rather than as nondeductible expenditures for capital improvements to property, expenditures for the clearing of land (including a reasonable allowance for depreciation with respect to depreciable property used in the clearing of land) if such expenditures are for the purpose of making the land suitable for use in farming.

The term "clearing of land" includes the eradication of trees, stumps, and brush, the treatment or moving of earth, and the diversion of streams and watercourses. The new section 182 limits the deduction for expenditures for the clearing of land for any taxable year to $5,000 or to 25 percent of the taxable income derived from farming during the taxable year, whichever amount is the lesser. The new section applies to taxable years beginning after December 31, 1962. The House recedes with clerical and conforming amendments.

CHARITABLE CONTRIBUTIONS MADE FROM INCOME ATTRIBUTABLE TO SEVERAL TAXABLE YEARS

Amendment No. 190: This amendment adds a new section to the bill, adding a new subsection (e) to section 1307 of the code, relating to rules applicable to part I of subchapter Q of chapter 1 of such code (which relates to income attributable to several taxable years).

When income attributable to several taxable years is received or accrued in a particular taxable year, part I of subchapter Q provides, under certain circumstances, that the tax attributable thereto for the taxable year in which it is received or accrued is, in general, not to be greater than the aggregate increases in taxes which would have resulted if the amount had been included in the taxpayer's income, on an allocated basis, over the period specified in the applicable section of such part I.

New subsection (e) provides that an individual who receives or accrues in a taxable year an amount to which part I of subchapter Q applies may elect (in such manner and at such time as the Secretary of the Treasury or his delegate prescribes by regulations) to apply the provisions of subsection (e) in computing his tax liability under such part. If the taxpayer so elects, the amount received or accrued shall be reduced, for the purposes of computing his tax liability under such part I with respect to such amount, by an amount (1) which bears the same ratio to the amount of his allowable charitable deduction for the taxable year in which the amount was received or accrued (computed without regard to pt. I of subch. Q) as (2) the amount received or accrued during the taxable year to which part I applies bears to the adjusted gross income for such year (computed without regard to pt. I of subch. Q).

New subsection (e) further provides that no portion of the amount received or accrued to which part I of subchapter Q applies shall (for purposes of computing the limitation on tax under such part) be taken into account for purposes of computing the limitation under section 170(b)(1) of the code for the taxable year in which the amount to which such part applies is received or accrued.

The House recedes with an amendment which is technical and clarifying in nature and is a substitute for the provision described in the preceding paragraph.

EFFECTIVE DATE OF SECTION 1371(C) OF THE INTERNAL REVENUE CODE OF 1954

Amendment No. 191: The Senate amendment adds a new section to the bill as passed by the House which provides that section 1371(c) of the code (relating to the determination of the number of shareholders of a small business corporation where stock is owned by a husband and wife) is, subject to the provisions for filing of election and consents described below, to apply to taxable years beginning

after December 31, 1957, and before January 1, 1960. Under existing law, section 1371(c), which was added to the code by section 2(a) of Public Law 86–376 (approved September 23, 1959), applies only to taxable years beginning after December 31, 1959. The Senate amendment provides a 1-year period within which an otherwise qualifying small business corporation may make a special election to have the earlier effective date of section 1371(c) apply. For the special election to be valid, a corporation must have previously filed a timely election to have its income taxed directly to its shareholders, and each person who is a shareholder at the time of the special election (as well as each person who was a shareholder for any taxable year beginning after December 31, 1957, and ending before the date on which the special election is made) must give his consent. The amendment also provides that where a special election (and the requisite consents) has been made, the statute of limitations for assessing additional tax against the corporation or the shareholders attributable to the earlier effective date of section 1371(c) (and the statute of limitations for allowing a credit or refund of any overpayment of tax by the corporation or its shareholders attributable to the earlier effective date of section 1371(c)) is to remain open, or be opened, for 1 year following the date of the election. The House recedes.

CERTAIN LOSSES SUSTAINED IN CONVERTING FROM STREET RAILWAY TO BUS OPERATIONS

Amendment No. 192: The Senate amendment adds a new section to the bill as passed by the House which provides that in the case of net operating losses incurred in the calendar years 1953 and 1954 principally as the result of conversion from street railway to bus operations, an additional 5 years, beginning with 1960, is to be allowed for the carryover of such losses. The Senate amendment applies only for years in which the taxpayer is engaged in the furnishing or sale of transportation (as defined in sec. 1503(c)(1)(A) of the 1954 code). The House recedes with a technical amendment.

PENSION PLAN OF LOCAL UNION NO. 435, INTERNATIONAL HOD CARRIERS' BUILDING AND COMMON LABORERS' UNION OF AMERICA

Amendment No. 193: The Senate amendment adds a new section to the bill as passed by the House which provides that the pension plan of Local Union No. 435 of the International Hod Carriers' Building and Common Laborers' Union of America, which was negotiated to take effect May 1, 1960, pursuant to an agreement between such union and the Building Trades Employers Association of Rochester, N.Y., shall be held and considered to have been a qualified trust under section 401(a) of the code, and to have been exempt from taxation under section 501(a) of the code, for the period beginning May 1, 1960, and ending April 20, 1961, but only if it is shown to the satisfaction of the Secretary of the Treasury or his delegate that the trust has not in this period been operated in a manner which would jeopardize the interests of its beneficiaries. The House recedes.

CONTINUATION OF A PARTNERSHIP YEAR FOR SURVIVING PARTNER IN A TWO-MAN PARTNERSHIP WHERE ONE DIES

Amendment No. 194: The Senate amendment adds a new section to the bill as passed by the House which amends section 188 of the

Internal Revenue Code of 1939 (relating to different taxable years of partner and partnership) to provide that for purposes of chapter 1 of the 1939 code, if the surviving partner so elects within 1 year after the date of enactment of this bill, the death of one of the partners of a partnership consisting of two members shall not result in the termination of the partnership or in the closing of the taxable year of the partnership with respect to the surviving partner prior to the time the partnership year would have closed if neither partner had died or disposed of his interest. The amendment is to apply to taxable years of a partnership beginning after December 31, 1946, to which the Internal Revenue Code of 1939 applies. The amendment further provides that if refund or credit of any overpayment resulting from the application of such amendment was prevented on the date of the enactment of the bill, or at any time within 1 year from such date by the operation of any law or rule of law (other than those relating to closing agreements and compromises), refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefor is filed within 1 year after the date of enactment of the bill. No interest is to be allowed or paid on any overpayment resulting from the application of the amendment. The House recedes.

EXCLUSION FROM GROSS INCOME OF CERTAIN AWARDS MADE PURSUANT TO EVACUATION CLAIMS OF JAPANESE-AMERICANS

Amendment No. 195: This amendment, which adds a new section to the bill, provides that awards received under the Japanese-American Evacuation Claims Act, as amended in 1951 and 1956 (50 U.S.C. App., secs. 1981–1987), are not to be included in gross income for purposes of chapter 1 of the Internal Revenue Code of 1939 or 1954. This treatment is to apply with respect to taxable years ending after July 2, 1948.

Any refund or credit of an overpayment of Federal income tax (including interest, additions to the tax, additional amounts, and penalties) resulting from this provision which is barred on the date of the enactment of this bill, or within 1 year from such date, by any law or rule of law may, nevertheless, be made, without interest, if a claim for such refund or credit is filed within 1 year after the date of enactment of the bill. In the case of any claim described in the preceding sentence, the amount to be refunded or credited as an overpayment is not to be diminished by any credit or setoff based on any item other than the amount of the award.

The House recedes with technical amendments.

DEDUCTION FOR BUSINESS DEPRECIATION BY TENANT-STOCKHOLDER OF COOPERATIVE HOUSING CORPORATION

Amendment No. 196: This amendment adds a new section to the bill, adding a new subsection (c) to section 216 of the code (relating to amounts representing taxes and interest paid to a cooperative housing corporation).

The new subsection (c) provides that so much of the stock of a tenant-stockholder in a cooperative housing corporation as is allocable, under regulations prescribed by the Secretary of the Treasury or his delegate, to a proprietary lease or right of tenancy in property subject to the allowance for depreciation under section 167(a) shall, to the extent that such proprietary lease or right of tenancy is used by such

tenant-stockholder in a trade or business or for the production of income, be treated as property subject to the allowance for depreciation under section 167(a). The amendment is effective with respect to taxable years beginning after December 31, 1961. The House recedes with clerical amendments.

EXCLUSION FROM GROSS INCOME OF GAIN FROM SALE OF RESIDENCE BY INDIVIDUAL AGE 65 OR OVER

Amendment No. 197: This amendment added a new section to the bill, adding a new section 121 to part III of subchapter B of chapter 1 of the code (relating to items specifically excluded from gross income). The new section 121, applicable only in the case of individuals, provided that gross income does not include gain from the sale, exchange, or involuntary conversion (within the meaning of sec. 121(e)) after December 31, 1962, of property used by the taxpayer as his principal residence, if (1) the taxpayer had attained the age of 65 years before the sale, exchange, or involuntary conversion, and (2) the property had been used by the taxpayer as his principal residence for a period of not less than 5 years at the time of its sale, exchange, or involuntary conversion. The Senate recedes.

DEDUCTION FOR INCOME TAX PURPOSES OF CONTRIBUTIONS TO CERTAIN ORGANIZATIONS FOR JUDICIAL REFORM

Amendment No. 198: This amendment, which adds a new section to the bill, provides that a contribution or gift made after December 31, 1961, with respect to a referendum occurring during the calendar year 1962, shall be deductible as a charitable contribution under section 170 of the code if made to, or for the use of, an organization created and operated exclusively to consider proposals for the reorganization of the judicial branch of any State or local government and to provide information, make recommendations, and seek public support or opposition to such proposals. For contributions or gifts to be eligible for this treatment, no part of the net earnings of the organization may inure to the benefit of any private shareholder or individual and the organization must not participate in any political campaign in behalf of, or in opposition to, any candidate for public office. The House recedes with a clerical amendment.

AMENDMENT TO SOCIAL SECURITY ACT RELATING TO STATEMENT OF FINANCIAL STATUS OF CLAIMANTS FOR MEDICAL ASSISTANCE FOR THE AGED

Amendment No. 199: This amendment added to the bill a new section, amending section 2(a) of the Social Security Act so as to permit a State to provide in its State plan under title I of such act that any written statement required of a claimant for medical assistance for the aged under that title shall be presumed by the State agency administering the plan to be factually correct for purposes of determining eligibility for such assistance insofar as the statement relates to the claimant's financial status. The Senate recedes.

FOREIGN SUBSIDIARIES MANUFACTURING PRODUCTS ABROAD FOR SALE IN THE UNITED STATES

Amendment No. 200: Senate amendment No. 200 added a new section to the bill to provide that foreign corporations to which the

proposed new section, section 885 of the code, applies are deemed to be engaged in trade or business within the United States, and their gross income from sources within the United States is deemed to be not less than their gross income from the sale of competitive articles sold for ultimate use, consumption, or disposition in the United States. The new section applied to a foreign corporation if at any time during the taxable year one or more domestic corporations own, directly or through one or more other corporations, 10 percent or more of the outstanding stock of the foreign corporation, and if for such taxable year the foreign corporation derives 10 percent or more of its gross income from the sale of competitive articles sold for ultimate use, consumption, or disposition in the United States. For such purpose a competitive article is any article mined, processed, or manufactured outside the United States for a foreign corporation which is the same as or similar to any article mined, processed, or manufactured in the United States (or formerly mined, processed, or manufactured in the United States) by any domestic corporation described in the preceding sentence with respect to the foreign corporation, or by any subsidiary of such domestic corporation. The new provision applied to taxable years beginning after December 31, 1962. The Senate recedes.

EFFECTIVE DATE OF AMENDMENT TO SECTION 1374(b) OF INTERNAL REVENUE CODE OF 1954

Amendment No. 201: The Senate amendment adds a new section to the bill as passed by the House which makes the amendment to section 1374(b) of the code, which was added by section 2(b) of Public Law 86-376 (approved Sept. 23, 1959), effective on September 2, 1958. Under existing law, the amendment to section 1374(b), which permits the deduction of a deceased shareholder's pro rata share of the net operating loss of an electing small business corporation incurred in the year in which he dies, is effective only with respect to taxpayers who die after September 23, 1959. The House recedes with a clerical amendment.

TREATIES

Amendment No. 203: The bill as passed by the House provided that section 7852(d) of the code, relating to treaty obligations, was not to apply in respect of any amendment made by the Revenue Act of 1962. Senate amendment No. 203 provides that no provision of the Revenue Act of 1962 will apply in any case where its application would be contrary to any treaty obligation of the United States.

The Senate recedes. In this connection, the Treasury Department informed the committee of conference that it is its view that there are no conflicts between provisions of the bill and provisions of tax treaties, with one minor exception relating to the real estate clause of the Greek Estate Tax Treaty which the Treasury will seek to have renegotiated before July 1, 1964.

W. D. Mills,
Cecil R. King,
Hale Boggs,
Eugene J. Keogh,
John W. Byrnes,
Howard H. Baker,
Managers on the Part of the House.

[H.R. 7283] [1]

PROVIDING COMPENSATION FOR AMERICAN NATIONALS FOR CERTAIN WORLD WAR II LOSSES

[House of Representatives Report No. 2035, Eighty-seventh Congress, Second Session]

[July 25, 1962]

Mr. Mack, from the Committee on Interstate and Foreign Commerce, submitted the following report to accompany H.R. 7283.

The Committee on Interstate and Foreign Commerce, to whom was referred the bill (H.R. 7283) to amend the War Claims Act of 1948, as amended, to provide compensation for certain World War II losses, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

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SECTION-BY-SECTION ANALYSIS

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Section 206. Deductions in making awards

Subsection (a) of this section provides that all awards made under the amendment shall be reduced by the amount which the claimant has received otherwise on account of the same loss.

Subsection (b) of this section provides that corporate claims in excess of $10,000 filed under this title must include a statement under oath showing the total Federal tax benefits derived by the corporation from the loss on account of which the claim was filed.

Any award made to a corporation under the amendment where the allowable loss exceeds $10,000, will be reduced by the aggregate amount of Federal tax benefits derived by such corporation on account of the same loss. This provision is necessary in order to prevent windfalls to a few claimants. Section 123 of the Internal Revenue Code of 1939 permitted the deduction for Federal income and excess profits purposes, of certain war losses. In view of the high wartime tax rates (as much as 95 percent in some cases), corporate claimants may have already received as tax benefits most of the loss suffered. Where such benefits have been received, and subsequent recovery is made, the recovery is taxable at present rates. Therefore, but for the offset provisions of this section, it would be possible for a claimant to receive more than 100 cents on the dollar for a loss.

The applicability of the subsection is limited to awards in excess of $10,000, in order to eliminate the administrative burdens that otherwise would be involved in numerous smaller claims.

[H.R. 8952] [2]

CONSTRUCTIVE SALE PRICE FOR PURPOSES OF CERTAIN MANUFACTURERS EXCISE TAXES

[House of Representatives Report No. 1265, Eighty-seventh Congress, First Session]

[September 23 (legislative day, September 22), 1961]

Mr. Mills, from the Committee on Ways and Means, submitted the following report to accompany H.R. 8952.

The Committee on Ways and Means, to whom was referred the bill (H.R. 8952) to amend the Internal Revenue Code of 1954 with respect to the conditions under which the special constructive sale price rule is to apply for purposes of certain manufacturers excise taxes, having considered the same, report favorably thereon with an amendment and recommended that the bill as amended do pass.

The amendment is as follows:

Page 2, line 3, strike out "1959" and insert "1962".

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[1] Public Law 87–846, page 205, this Bulletin.
[2] Public Law 87–858, page 206, this Bulletin.

I. SUMMARY OF BILL

The Excise Tax Technical Changes Act of 1958 provided that in determining the base for the computation of manufacturers excise taxes, a constructive sales price could be used where sales were made to retailers or to consumers if sales were also made at the wholesale level. However, this provision applies only if the normal method of sales within the industry is not to sell articles at retail, to retailers, or to both. This bill provides that this latter restriction will not apply in the case of the manufacturers excise taxes on refrigerators and related items, on electric, gas, and oil appliances, and on radios and television sets and related items.

This bill has been reported unanimously by your committee.

II. GENERAL STATEMENT

Prior to the enactment of the Excise Tax Technical Changes Act of 1958 the law provided a constructive sales price, for purposes of computing various manufacturers excise taxes, only where an article is sold (1) at retail (i.e., to consumers), (2) on consignment, or (3) at less than the fair market price if the transaction is not at arm's length. The constructive sales price applied in such cases is the price for which the articles are sold in the ordinary course of trade by the manufacturer or producer as determined by the Secretary of the Treasury or his delegate.

In the Excise Tax Technical Changes Act of 1958 (Public Law 85–859, 85th Cong.),[3] Congress expanded the area where a constructive price provision applies in determining the base for manufacturers excise taxes. A provision added by that act made a constructive price provision applicable not only to sales to consumers but also in the case of sales to retailers.[4] Where this provision applies, the applicable constructive sales price is the highest price for which the manufacturer sells the article to wholesale distributors, or the actual price for which the article was sold, if lower.

In the report on the 1958 act your committee recognized

> the desirability of imposing manufacturers' excise taxes on a uniform base. even though various manufacturers may sell the same articles at different levels of distribution.

Your committee further stated:

> In the case of two taxable articles ultimately sold to the consumer for the same price, exclusive of tax, your committee can see no reason for imposing substantially different amounts of manufacturers' tax merely because one manufacturer chooses to sell his to a dealer.

Despite the objective of a uniform base for the imposition of excise taxes, it was recognized in the action taken in the 1958 act that there were significant administrative problems in computing a constructive sales price which made it difficult to achieve complete uniformity in tax base for purposes of the manufacturers' excise taxes. To minimize these administrative problems, four limitations were imposed on the use of this new provision:

(1) The sales must be regularly made at retail, to retailers, or to special dealers;

(2) Sales must also be made to one or more wholesale distributors in arm's-length transactions in which the manufacturer (producer or importer) establishes that the price was set without regard to any tax benefit under this provision;

(3) The normal method of sales of the articles within the industry is not at retail, or to retailers or a combination of both; and

(4) The transaction is at arm's length.

The first limitation means that the provision does not apply where the sales at retail or to retailers are merely casual sales. The requirement that sales also be made to wholesalers provides a basis for the actual computation of the constructive price. The third limitation, namely, the requirement that the sales at retail or to retailers (or a combination of these types of sales) not be the normal method

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[3] C.B. 1958–3, 92.

[4] This act also applied the constructive sales price provision to so-called special dealers.

of distribution was intended to deny the benefit of this provision where half or more of the volume of sales of the specific category of taxable items is made at retail or to retailers. The committee report on the 1958 act indicated the following reason for this limitation:

> This limitation on the application of the new constructive price provision appears desirable because there would seem to be no significant discrimination with respect to an industry where sales at retail and to retailers represent the major proportion of their volume sales in the industry.

This requirement that taxpayers determine whether or not the normal method of distribution within the industry is to retailers or at retail in practice has been practically impossible to meet. The difficulty is that it has been almost impossible to gather the statistical information needed in order to determine what is the normal method of distribution within an industry. In most cases it has proved impossible to obtain sales data for important segments of the industry. In part this is due to a natural reluctance to disclose trade data to competitors, in part due to the fact that those who do not intend to use this provision have no interest in developing this data, and in part due to the fact that there is no authorized agency for the collection of the data. However, problems also arise from the nature of the distribution system. For example, sales to large contractors frequently are difficult to classify as to whether they are sales at wholesale, to retailers, or at retail because the contractor may, in part, be purchasing articles for his own use and in part for resale to others. The problem is further complicated by the fact that a determination as to the normal method of distribution at any one point of time may vary somewhat if another point of time is selected.

The Treasury Department, in its report on this bill, while not favoring its enactment stated:

> * * * While there is a feeling by all concerned that certain products must fall within the scope of the lower constructive price provision (i.e., the one under consideration here), conclusive data for any given product have yet to be obtained. Normal sources of distribution data are the census of manufacturers and trade associations. But differences in classification of products for trade and tax purposes, and lack of full coverage for a whole industry, have prevented available figures from being sufficient to make a decision as to whether sales to retailers and at retail are, or are not, the normal method of distribution by manufacturers of a given product. [Parenthetical statement added.]

As a result of these difficulties in the application of this restriction relating to the normal method of distribution within an industry, your committee has concluded that the application of this restriction should be removed in the case of three industry groups, where it is generally agreed that the normal method of distribution within the industry is not sales to retailers or at retail, despite the fact that complete statistical proof to this effect has not been available. The industry groups referred to are those selling articles taxable under—

(1) section 4111; namely, household-type refrigerators and quick-freeze units (including combinations of the two), and self-contained air-conditioning units;

(2) section 4121; namely, electric, gas, and oil appliances; and

(3) section 4141; namely, radios, television sets, phonographs (including combinations of the foregoing, radio and television components, and phonograph records.

This bill, therefore, amends section 4216(b)(2) of the code, which contains the special rule for determining constructive sales price referred to above, to provide that the provision limiting the application of this rule to those industries where the normal method of sales of the articles is not at retail or to retailers (or a combination of the two) is not to apply in the case of articles taxable under the three sections referred to above; namely, sections 4111, 4121, and 4141.

This provision is to apply with respect to articles sold by the manufacturer, producer, or importer on or after January 1, 1962. This is not intended, however, to imply that this constructive price rule was not applicable to sales of articles covered by this bill prior to that date.

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[H.R. 8952][5]

CONSTRUCTIVE SALE PRICE FOR PURPOSES OF CERTAIN MANUFACTURERS EXCISE TAXES

[Senate Report No. 2109, Eighty-seventh Congress, Second Session, Calendar No. 2075]

[September 19, 1962]

Mr. BYRD of Virginia, from the Committee on Finance, submitted the following report together with supplemental views to accompany H.R. 8952.

The Committee on Finance, to whom was referred the bill (H.R. 8952) to amend the Internal Revenue Code of 1954 with respect to the conditions under which the special constructive sale price rule is to apply for purposes of certain manufacturers excise taxes, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

I. SUMMARY OF BILL

The Excise Tax Technical Changes Act of 1958 provided that in determining the base for the computation of manufacturer's excise taxes, a constructive sales price could be used where sales were made to retailers or to consumers if sales were also made at the wholesale level. However, this provision applies only if the normal method of sales within the industry is not to sell articles at retail, to retailers, or to both. The House bill provided that this latter restriction was not to apply in the case of the manufacturer's excise taxes on refrigerators and related items, on electric, gas and oil appliances, and on radios and television sets and related items. Your committee has amended the House bill to provide that this latter restriction is to apply in the case of none of the manufacturer's excise taxes except those relating to automobiles, trucks and buses, business machines, and matches.

Your committee also has added two new sections to the bill. The first of these relates to the extra 10 percent limitation, over and above the generally available 20 percent limitation, on deductions for charitable contributions. Presently this extra 10 percent limitation applies in the case of contributions to a church, school, hospital, or medical research organization. The new section added by your committee makes this extra 10 percent limitation applicable in the case of contributions to an organization, organized and operated exclusively to receive, hold, invest, and administer property and to make expenditures to, or for the benefit of, a State or local government university or college, including a land-grant college or university. However, such an organization must be one which normally receives a substantial part of its support from the United States or any State or local government or from direct or indirect contributions from the general public. This new section is to apply to taxable years beginning after December 31, 1960.

The second new section added to the bill by your committee deals with certain aspects of the taxation of life insurance companies. The amendment makes four changes in life insurance taxation:

First, the amendment affects the tax treatment of variable annuities and segregated pension contracts. The present tax treatment of variable annuities does not apply to taxable years beginning after December 31, 1962. The bill continues present treatment of variable annuities for the future, without a termination date, and also provides that income allocated to "segregated asset accounts" (including capital gains income in the case of qualified pension contracts) is not to be taxed to the life insurance company.

The second life insurance company amendment is concerned with the taxation of capital gains of such companies. The bill permits taxpayers to include the excess of any net long-term capital gains over any net short-term capital losses in the life insurance company's "phase one" investment income tax base, in lieu of the present separate capital gains tax of 25 percent.

The third life insurance company amendment is concerned with the order in which deductions are to be taken. Under present law the 2 percent deduction for group accident and health insurance and the 10 percent deduction for in-

[5] Public Law 87-858, page 206, this Bulletin.

crease in reserves for nonparticipating contracts (or deduction of 3 percent of the premiums on such contracts), for purposes of the $250,000 limitation, are taken before the deduction for policyholder dividends. The amendment reverses this priority. Since the deductions for group accident and health insurance and nonparticipating contracts in effect are restored to income for purposes of the "phase three" tax, when distributions are made to stockholders, there is a wastage for the life insurance company of part of its policyholder dividend deduction (which is not restored to income at the time of distributions) if this latter deduction is not taken first.

The fourth life insurance company amendment provides that if an amount added to the policyholder's surplus account for any year increased a loss from operations for that year, and did not result in a reduction in tax in any year to which the loss is carried, to this extent the income base used in determining the tax at the time of distributions to shareholders is to be reduced.

These life insurance company amendments are to apply to taxable years beginning after December 31, 1961.

The Treasury Department has indicated that if the constructive price provision for present law is to be retained, it does not object to the House bill and favors the amendment made by your committee. The Treasury Department also has indicated that it favors the committee amendments relating to the extra 10-percent deduction for charitable contributions and those relating to life insurance company taxation.

II. CONSTRUCTIVE SALES PRICE PROVISION

Prior to the enactment of the Excise Tax Technical Changes Act of 1958, the law provided a constructive sales price, for purposes of computing various manufacturers excise taxes, only where the article is sold (1) at retail (i.e., to consumers), (2) on consignment, or (3) at less than the fair market price if the transaction is not at arm's length. The constructive sales price applied in such cases is the price for which the articles are sold in the ordinary course of trade by the manufacturer or producer as determined by the Secretary of the Treasury or his delegate.

In the Excise Tax Technical Changes Act of 1958 (Public Law 85–859, 85th Cong.),[6] Congress expanded the area where a constructive price provision applies in determining the base for manufacturers excise taxes. A provision added by that act made a constructive price provision applicable not only to sales to consumers but also in the case of sales to retailers.[7] Where this provision applies, the applicable constructive sales price is the highest price for which the manufacturer sells the article to wholesale distributors, or the actual price for which the article was sold, if lower.

In its report on the 1958 act, the Senate Committee on Finance stated:

> Your committee is in full agreement with the House that substantially different amounts of manufacturers' excise tax should not be imposed with respect to the same type of items merely because one manufacturer chooses to sell his articles to a retailer or consumer while the other sells his to a wholesaler.

Despite the objective of a uniform base for the imposition of excise taxes, it was recognized in the action taken in the 1958 act that there were significant administrative problems in computing a constructive sales price which made it difficult to achieve complete uniformity in tax base for purposes of the manufacturers' excise taxes. To minimize these administrative problems, four limitations were imposed on the use of this new provision:

(1) The sales must be regularly made at retail, to retailers, or to special dealers;

(2) Sales must also be made to one or more wholesale distributors in arm's-length transactions in which the manufacturer (producer or importer) establishes that the price was set without regard to any tax benefit under this provision;

(3) The normal method of sales of the articles within the industry is not at retail, or to retailers or a combination of both; and

(4) The transaction is at arm's length.

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[6] C.B. 1958–3, 92.

[7] The act also applied the constructive sales price provision to so-called special dealers.

The first limitation means that the provision does not apply where the sales at retail or to retailers are merely casual sales. The requirement that sales also be made to wholesalers provides a basis for the actual computation of the constructive price. The third limitation, namely, the requirement that the sales at retail or to retailers (or a combination of these types of sales) not be the normal method of distribution was intended to deny the benefit of this provision where half or more of the volume of sales of the specific category of taxable items is made at retail or to retailers. The report of the Senate Committee on Finance on the 1958 act indicated the following reason for this limitation:

> This limitation on the application of the new constructive price provision appears desirable because there would seem to be no significant discrimination with respect to an industry where sales at retail and/or to retailers represent the major proportion of the volume sales in the industry.

This requirement that taxpayers determine whether or not the normal method of distribution within the industry is to retailers or at retail in practice has been practically impossible to meet. The difficulty is that it has been almost impossible to gather the statistical information needed in order to determine what is the normal method of distribution within an industry. In most cases it has proved impossible to obtain sales data for important segments of the industry. In part this is due to a natural reluctance to disclose trade data to competitors, in part due to the fact that those who do not intend to use this provision have no interest in developing this data, and in part due to the fact that there is no authorized agency for the collection of the data. However, problems also arise from the nature of the distribution system. For example, sales to large contractors frequently are difficult to classify as to whether they are sales at wholesale, to retailers, or at retail because the contractor may, in part, be purchasing articles for his own use and in part for resale to others. The problem is further complicated by the fact that a determination as to the normal method of distribution at any one point of time may vary somewhat if another point of time is selected.

The Treasury Department, in its report to your committee on this bill, while not favoring its enactment, stated:

> * * * While there is a feeling by all concerned that certain products must fall within the scope of the lower constructive price provision (i.e., the one under consideration here), conclusive data for any given product have yet to be obtained. Normal sources of distribution data are the census of manufacturers and trade associations. But differences in classification of products for trade and tax purposes, and lack of full coverage for a whole industry, have prevented available figures from being sufficient to make a decision as to whether sales to retailers and at retail are, or are not, the normal method of distribution by manufacturers of a given product. [Parenthetical statement added.]

As a result of these difficulties in the application of this restriction relating to the normal method of distribution within an industry, the House concluded that the application of this restriction should be removed in the case of three industry groups, where it is generally agreed that the normal method of distribution within the industry is not sales to retailers or at retail, despite the fact that complete statistical proof to this effect has not been available. The industry groups referred to were those selling articles taxable under—

(1) section 4111; namely, household-type refrigerators and quick-freeze units (including combinations of the two), and self-contained air-conditioning units;

(2) section 4121; namely, electric, gas, and oil appliances; and

(3) section 4141; namely, radios, television sets, phonographs (including combinations of the foregoing), radio and television components, and phonograph records.

Your committee agrees with the House that the restriction as to the normal method of sales of the article within the industry should not apply in the case of the above-named excise tax categories. However, your committee after examining this provision has concluded that this restriction likewise should not apply in the case of other manufacturer's excise taxes as well. In this regard the Treasury report on this bill states as follows:

> It is our understanding that the major objective in 1958, in inserting the condition that the new constructive price privilege was not to be available where sales at retail or to retailers were the normal method of selling, was

designed to prevent the use of such constructive price by a limited group of industries. These industries are those in which sales at retail or to retailers constitute a very high proportion of total sales, in particular, passenger automobiles, trucks, and business and store machines. Amending the law so as to prevent only these named industries from using the constructive price base in question would achieve the essential intent of 1958 legislation and avoid the need for considering additional amendments in future years to meet the requests of industries which presumably are in the same situation as the industries already listed in H.R. 8952.

Your committee agrees with the Treasury Department that this restriction of the constructive sales price privilege, so that it is not available where sales at retail or to retailers is the normal method of selling, should not apply generally to manufacturer's excise taxes. For that reason it has amended the House bill to make this restriction applicable only in the case of the following excise taxes:

(1) Section 4061(a)(1); namely, trucks, buses, and related equipment;

(2) Section 4061(a)(2); namely, passenger automobiles and related equipment;

(3) Section 4191; namely, business machines; and

(4) Section 4211; namely, matches.

Because of the elapse of time since this provision was considered by the House, your committee has also amended the effective date so that the amendment made by this section is to apply with respect to articles sold by the manufacturer, producer or importer on or after October 1, 1962, rather than January 1, 1962. This is not intended, however, to imply that this constructive sales price was not applicable to sales of articles covered by this bill prior to that date.

III. CONTRIBUTIONS TO FOUNDATIONS FOR STATE COLLEGES AND UNIVERSITIES

The attention of your committee has been called to the fact that in at least nine States[8] legal restrictions limit the ability of State and land-grant colleges or universities to receive directly gifts and bequests from the public for particular purposes. This frequently is true because State laws require gifts made directly to a State institution to be covered into the general State treasury, and for funds made available to the State university or college to be provided by appropriation by the legislature. Because of these restrictions, endowment foundations had been created in connection with many State colleges and universities (often by alumni groups) for the purpose of receiving gifts and bequests from the general public and making expenditures for the benefit of these colleges and universities. In some instances State university endowment institutions of the type referred to here hold title to property comprising part of the campus area of a college or university and participate in the erection of university buildings. In general, the funds of these foundations are used for a variety of purposes such as providing scholarships, student loans, equipment, furnishings and libraries, all of which normally are accepted functions of colleges and universities. However, in these cases the functions are performed through separate corporations rather than through the university corporation itself.

Because these university endowment institutions are not directly a part of the State university or college, the charitable contribution deduction which may be taken by an individual with respect to contributions to such an institution is limited to 20 percent of the taxpayer's adjusted gross income (without regard to net operating loss carrybacks). Under present law an extra 10 percent, or 30 percent in the aggregate, of the taxpayer's adjusted gross income may be deducted in the case of contributions to a church or convention or association of churches, an educational organization, a hospital, or certain medical research organizations. This extra 10 percent, however, may not be deducted in the case of the State university endowment institutions referred to here because they are not actually schools. Similar endowment funds of private universities or colleges, on the other hand, are a part of the private school or university itself and, therefore, contributions to such funds or directly to the private schools and universities are eligible for this extra 10 percent charitable deduction.

Your committee has concluded that these endowment funds for colleges or universities of States or local governments should be placed on the same footing

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[8] Iowa, Kansas, New York, Oregon, South Dakota, Utah, Virginia, West Virginia, and Wisconsin.

with private institutions in the case of the deductibility of charitable contributions and gifts made to them. For that reason your committee's amendment adds a new category (sec. 170(b)(1)(A)(iv)) to the provision of present law which specifies the types of institutions to which gifts may be made for which the extra 10-percent deduction for charitable contributions is available. The new category added by your committee's amendment comprises organizations, organized and operated exclusively to receive, hold, invest, and administer property and to make expenditures to or for the benefit of a State (or local governmental unit) university or college, including land-grant colleges or universities. To be eligible for this treatment, however, the organization must be one which normally receives a substantial part of its support from the United States or a State or local governmental unit or from direct or indirect contributions from the general public.

This provision is to apply to taxable years beginning after December 31, 1960.

IV. AMENDMENT OF PROVISIONS RELATING TO THE TAXATION OF LIFE INSURANCE COMPANIES

A. GENERAL EXPLANATION

1. Variable annuities and other segregated asset accounts

The first provision relating to life insurance companies added by your committee's amendments deals with variable annuities and also with segregated pension accounts.

Variable annuities differ from ordinary, or fixed dollar, annuities in that the annuity benefits payable under them very with the insurance company's investment experience. The fixed dollar annuity, on the other hand, guarantees the payment of a specified amount irrespective of the actual investment earnings. Both the fixed dollar annuities and the variable annuities, however, are based upon the principle of paying out either specified amounts, or specified units with values which vary with investment experience, over the life of each member of an annuitant group. In both cases the insuring company bears the mortality risk.

In view of this similarity, Congress in the Life Insurance Company Income Tax Act of 1959 treated variable annuities generally like other annuities for tax purposes. It provided that variable annuity contracts using recognized mortality tables with annuity payments based on the investment experience of the company issuing the contract were to be treated as regular annuity contracts for purposes of the life insurance company tax. These reserves, therefore, qualify as life insurance reserves and companies primarily issuing these policies qualify as life insurance companies. In this case, however, the current earnings rate of the company is used in determining the portion of the investment income belonging to the policyholder, rather than to the life insurance company, except that this current earnings rate is reduced by any actuarial margin charge retained by the company under the contract. This same rate is also used as the assumed rate of interest. In th› case of these variable annuity contracts, additions in reserves for tax purposes include only increases made by reason of premium receipts and investment income and decreases in these reserves take into account only benefits paid under these contracts. There is excluded from reserve additions or decreases capital gains and losses, both realized and unrealized. The unrealized gains and losses are excluded because as a general rule unrealize gains are not taken into account for tax purposes. The realized gains and losses are excluded because under present law they are taxed at a separate flat 25 percent tax rate with respect to any excess net long-term capital gain over any net short-term capital loss.

Present law provides that the treatment described above for variable annuities is to terminate with respect to taxable years beginning after December 31, 1962. Your committee's amendment, with only technical modifications, continues the present treatment for these variable annuities for future years.

The variable annuity described above is one form of a segregated asset account. In addition, however, th‹‑e are segregated asset accounts, primarily pension contracts, where the payments may not be based upon recognized mortality tables. The segregated asset accounts referred to are those which provide for the payment of annuities where as a result of State law or regulation the amounts received are segregated from the general asset accounts of the life insurance company and where either the amounts paid in, or the amounts paid out as

annuities, vary with the investment return and the market value of the segregated asset account.

Under the Life Insurance Company Income Tax Act of 1959 Congress attempted to exclude the investment income earned in connection with reserves accumulated for qualified employer pension and profit-sharing plans from the tax base of the life insurance company. To obtain this result it provided that the amount to be attributed to the policyholders, and therefore not taxed, was to be equal to the current earnings rate of the life insurance company multiplied by reserves held for qualified pension and profit-sharing plans. Your committee's report on that act indicated the view that this treatment was desirable because the investment earnings of a noninsured qualified pension or profit-sharing trust are completely exempt from tax while they are accumulated in the trust.

Thus, an attempt was made at that time to treat qualified pension or profit-sharing contracts, handled through an insurance company, in the same manner as tax-exempt qualified pension and profit-sharing trusts. This result was not obtained, however, because the current earnings rate of a life insurance company is based on items of investment yield and assets of the company as a whole and not on those items as they relate to qualified pension plan contracts alone. Moreover, under present law the capital gains of all assets relating to these pension contracts remain subject to tax. Noninsured pension trusts, on the other hand, account separately for all assets attributable to qualified pension plans and pay no tax on either the investment income or the capital gains on such assets.

This difference in tax treatment may well be an important factor in the loss of pension business which has occurred in the case of life insurance companies in the last few years. In 1960 the premiums and other consideration they received for insured pension plans, for example, were $145 million lower than in 1959. This difference in tax treatment is damaging, however, not only to the life insurance companies but also to the smaller employers who generally cannot assume the risk or administrative expense of establishing a small pension trust.

In the last few years a number of States have authorized the use of segregated account pension contracts to enable life insurance companies to meet the competition of the pension trusts. These States are Arkansas, Colorado, Connecticut, Florida, Indiana, Iowa, Kentucky, Massachusetts, Nebraska, Nevada, New Jersey, New York, and the District of Columbia. However, to provide tax equality for these segregated pension accounts with the tax-exempt pension trusts, it is necessary that the investment income and capital gains credited to policyholders in these segregated accounts be free of tax in the same manner as is already true in the case of the noninsured pension trusts.

Your committee's amendment is designed to remove this competitive discrimination. First, it provides that the full current earnings rate on assets held in segregated accounts, less any amounts retained by the company in excess of allowable expenses, are to be deducted in computing the life insurance company's investment income tax base. This is provided in the amendment by specifying that in computing the policy and other contract liability requirements of the life insurance company with respect to life insurance reserves on segregated asset accounts, the current earnings rate with respect to these segregated accounts is to be substituted for the use of the adjusted reserve rate and the rate of interest assumed by the taxpayer. However, this current earnings rate is to be reduced for amounts retained by the life insurance company from gross investment income on segregated assets to the extent these retained amounts exceed the investment deductions otherwise allowable. Similarly, with respect to reserves based on segregated asset accounts other than life insurance reserves, the current earnings rate on the segregated assets is to be considered as the interest paid.

Second, capital gains and losses specifically allocated to segregated asset accounts are no longer to be subjected to the flat 25-percent capital gains tax. This treatment is provided, however, only in the case of qualified pension contracts. This is accomplished by adjusting the basis of the segregated assets upward or downward to the extent of the amount of the gain or loss which would otherwise occur.

Third, in determining the "phase two" tax base, or net gains from operation, increases or decreases in reserves for the contracts which would otherwise occur because of appreciation or depreciation in the value of assets is not to be taken into account. This, like the first adjustment described above, applies to qualified and nonqualified pension contracts alike.

Fourth, in determining the "phase one" tax base, namely, the taxable investment income, a completely separate computation is made for the investment income attributable to the segregated account business.

2. Tax on capital gains

Under the Life Insurance Company Income Tax Act of 1959 a life insurance company is taxed separately on its capital gains. That act provided that the excess of net long-term capital gains over net short-term capital losses is to be taxed at a flat 25-percent rate. This method of taxing capital gains differs from that provided for most other corporations in that this 25-percent tax is not an alternative tax but rather is the only procedure provided for capital gains.

As indicated in the report of your committee on the Life Insurance Act, the taxation of capital gains was limited to this one procedure because of complexities encountered in including capital gains in the regular tax base. In this regard the report of your committee on that act stated as follows:

> The tax rate is a flat 25 percent tax on these long-term gains (the excess of the net long-term capital gain over the net short-term capital loss). This differs from the treatment provided in the case of ordinary corporations in that this 25 percent tax is not an alternative tax but the only method of computation provided. This omission of any alternative method of computation avoids the complexity of providing for the inclusion of capital gains in the regular tax base, which in this case consists of three different phases.

The failure to permit insurance companies on an alternative basis to include capital gains in their regular tax base has resulted in a hardship for those companies operating at a loss. For the most part these are small, new companies. Moreover, they represent an important segment of the industry. In 1958, out of 1,471 life insurance companies, only 741 reported net income. Thus, nearly 50 percent of the industry in terms of numbers of companies operated at a loss. Any of these companies realizing a net long-term capital gain (in excess of any net short-term capital loss) nevertheless are required to pay a flat 25 percent tax on such a gain even though operating at an overall loss for the year.

Your committee's amendment removes this discriminatory treatment against life insurance companies operating at a loss and at the same time avoids the complexities feared at the time of the passage of the 1959 act. Under this amendment a life insurance company will compute its tax on long-term capital gains under two methods—a regular method and an alternative method. The regular method requires that these capital gains be included in the taxable investment income of the life insurance company.[9] Under this method, however, the capital gain income is not taken into account in determining investment yield.

The alternative method of taxing capital gains under your committee's amendment is identical to the method provided by existing law; namely, a separate flat 25 percent tax on the excess of any net long-term capital gain over any net short-term capital loss. The life insurance company, under your committee's amendment, is to determine its tax for the taxable year under whichever of these two methods produces the lesser tax liability.

3. Priority of deductions affecting stock life insurance companies

Under the Life Insurance Company Income Tax Act of 1959 a so-called phase three tax is imposed on life insurance companies, in the case of distributions to shareholders. The act provides that after distributions to the shareholders of amounts already taxed to the life insurance company, if additional distributions are made to the shareholders such amounts are taxable at the life insurance company level at the time of the distribution. The amounts so taxed at the time of distribution include the 50 percent of gains from operations (in excess of taxable income) not previously taxed to the life insurance company, plus the deduction for nonparticipating contracts (10 percent of the increase in reserves for nonparticipating contracts or 3 percent of the premiums for such contracts, whichever is greater) and the deduction for group life and group accident and health insurance contracts (2 percent of premiums for such contracts).

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[9] The excess of the net long-term capital gains over the net short-term capital losses are also included in gains from operations under the "phase two" tax base for life insurance companies. However, since in the final computation of the tax taxable investment income, if smaller, is subtracted from gain from operations, only the "phase one" tax base in the last analysis generally will include this capital gain income.

In computing the deductions for group insurance premiums and nonparticipating insurance and also the deduction for dividends to policyholders, the 1959 act provides that the aggregate of these three deductions (although they may entirely offset gains from operations in excess of taxable investment income) may not offset taxable investment income by more than $250,000. The statute also provides that the group insurance premium deduction is to be taken first, then the nonparticipating contract deduction, and finally the deduction for policyholder dividends in applying this $250,000 limitation.

The effect of this priority in which the deductions are to be taken is in some cases to leave a taxpayer worse off than if he received no deduction at all for group premiums or nonparticipating contracts. This can occur where the company pays out sufficient policyholder dividends to account for the maximum deduction available with this $250,000 limitation. In such a case, if this deduction could be taken first, since it is not just a deferred deduction, it would result in no further tax at the time of the distribution to the shareholder. However, since the other two deductions must be taken first and do result in a tax at the time of a distribution to shareholders, the taxpayer in such case is in a worse position than he would be if these first two deductions were not available.

To remove this hardship your committee's amendment provides that in applying the $250,000 limitation, policyholder dividends are to be allowed as a deduction first and then the deduction for group insurance premiums and finally the deduction for nonparticipating insurance contracts.

4. Effect of an unused loss from operations on "phase three" tax at time of distribution to shareholders

Under the Life Insurance Company Income Tax Act of 1959 provision was made for the taxation at the life insurance company level of any income not previously taxed to the life insurance company which is distributed to the shareholders. First, however, amounts which have already been taxed to the life insurance company may be distributed to shareholders without further tax at the time of distribution. Only when such amounts are used up is a tax imposed with respect to any additional distributions. The amounts already taxed to the life insurance company and which may be distributed without further tax are accounted for in what is called the shareholders' surplus account. The amounts which will result in additional tax at the time of distribution to shareholders are accounted for in the "policyholder's surplus account."

The attention of your committee has been called to a type of situation where these accounts do not achieve the intended result. At present there is added to the policyholder surplus account 50 percent of the gains from operation in excess of taxable investment income, plus the deduction for nonparticipating contracts and the deduction for group life and group accident and health insurance. The deduction for nonparticipating contracts or the deduction for group life and group accident and health insurance contracts may result in a loss from operations which may be carried back 3 years or forward 5 years (or in certain cases carried forward 8 years). If the deduction cannot be fully used to offset gain from operations in one of these years, there is a wastage of these deductions. Nevertheless, these deductions under present law have been added in full to the policyholder's surplus account. This results in a tax at the time distributions are made even though, where the deduction has been wasted, it has not been possible for the life insurance company to gain any benefit from them.

To remove this imperfection in the present statute, your committee's amendments provide that if an amount added to the policyholder's surplus account for any year increases or creates a loss from operations and part or all of that loss cannot be used in any other year to reduce the company's tax liability, then the policyholder's surplus account for the last year to which this loss may be carried is to be reduced by the amount of the unused loss or, if lesser, the amount in the policyholder's account (before making any subtractions for that year).

5. Effective date

All of the amendments made by your committee relating to life insurance companies apply with respect to taxable years beginning after December 31, 1961.

B. TECHNICAL EXPLANATION

Section 3 of the bill, which is a new section added to the bill as passed by the House, amends part 1 of subchapter L of chapter 1 of the Internal Revenue Code of 1954 (relating to the taxation of the income of life insurance companies).

(a) *Variable annuities and other segregated asset accounts.*—Subsection (a) of section 3 of the bill revises section 801(g) of the Internal Revenue Code of 1954, relating to variable annuities.

Subparagraph (A) of paragraph (1) of the new section 801(g) provides that, for purposes of part I of subchapter L, an "annuity contract" includes a contract which provides for the payment of a variable annuity that is computed on the basis of recognized mortality tables and the investment experience of the company issuing the contract. The language of the new section 801(g)(1)(A) is identical with the language of section 801(g)(1) in existing law.

Subparagraph (B) of paragraph (1) of the new section 801(g) is a new provision which provides that, for purposes of part 1 of subchapter L, the term "contract with reserves based on a segregated asset account" means a contract—

(i) which provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company;

(ii) which provides for the payment of annuities; and

(iii) under which the amounts paid in, or the amounts paid as annuities, reflect the investment return and the market value of the segregated asset account.

A pension contract written on the basis of the so-called new money concept, i.e., whereby reserves are credited on the basis of the company's new high yield investments, is not included within the meaning of such term. However, the fact that a contract provides for the payment of an annuity computed on the basis of recognized mortality tables does not cause it to be excluded from the meaning of such term.

Paragraph (1) further provides that, if a contract described in subparagraph (B) ceases to reflect current investment return and current market value, such contract is not to be considered as meeting the requirements of the new section 801(g)(1)(B)(iii) after such cessation.

Thus, "a contract with reserves based on a segregated asset account" includes a contract under which the reflection of investment return and market value terminates at the beginning of the annuity payments, but such contract would qualify under the definition only for the period prior to such termination.

Paragraph (2) of the new section 801(g) provides that, for purposes of section 801(b)(1)(A), the reflection of the investment return and the market value of the segregated asset account shall be considered an assumed rate of interest. Thus, for purposes of determining whether reserves based on a segregated asset account qualify as life insurance reserves under section 801(b), such reserves are considered as computed on the basis of an assumed rate of interest. Accordingly, such reserves constitute "life insurance reserves" if they fulfill the other requirements of section 801(b).

Paragraph (3) of the new section 801(g) provides that, for purposes of part I of subchapter L, a life insurance company which issues contracts with reserves based on segregated asset accounts is to separately account for the various income, exclusion, deduction, asset, reserve, and other liability items which are properly attributable to such segregated asset accounts. This paragraph further provides that, in those cases where such items are not directly accounted for, separate accounting is to be made—

(A) in accordance with the method regularly employed by the company, if such method is reasonable; and

(B) in all other cases, in accordance with regulations prescribed by the Secretary of the Treasury or his delegate.

Subparagraph (A) of paragraph (4) of the new section 801(g) provides that, for purposes of part 1 of subchapter L, the policy and other contract liability requirements (as determined under sec. 805), and the life insurance company's share of investment yield (as determined under sec. 804(a) or 809(b), shall be separately computed—

(i) with respect to the items separately acccounted for in accordance with paragraph (3); and

(ii) excluding the items taken into account under clause (i) of this subparagraph.

Thus, for purposes of determining both taxable investment income and gain or loss from operations, a life insurance company is required to separately compute the life insurance company's share of the investment yield on the assets in its segregated asset account without regard to the policy and other contract

liability requirements of, and the investment income attributable to, contracts with reserves that are not based on the segregated asset account.

Subparagraph (B) of paragraph (4) provides that, if the net short-term capital gain (as defined in sec. 1222(5)) exceeds the net long-term capital loss (as defined in sec. 1222(8)), determined without regard to any separate computations under subparagraph (A) of this paragraph, such excess shall be allocated between clauses (i) and (ii) of subparagraph (A). Such allocation shall be in proportion to the respective contributions to such excess of the items taken into account under each such clause. The allocation under this subparagraph shall be made before the separate computations prescribed by subparagraph (A).

Paragraph (5) of the new section 801(g) provides that, for purposes of part I of subchapter L—

(A) the adjusted reserves rate and the current earnings rate for purposes of section 805(b), and the rate of interest assumed by the taxpayer f. r purposes of sections 805(c) and 809(a)(2), with respect to life insurance reserves based on segregated asset accounts, shall be a rate equal to the current earnings rate determined under section 805(b)(2) with respect to the items separately accounted for in accordance with paragraph (3), reduced by the percentage obtained by dividing—

(i) any amount retained with respect to such reserves by the life insurance company from gross investment income (as defined in sec. 804(b)) on segregated assets, to the extent such retained amount exceeds the deductions allowable under section 804(c) which are attributable to such reserves, by

(ii) the means of such reserves; and

(B) with respect to reserves based on segregated asset accounts other than life insurance reserves, an amount equal to the product of—

(i) the rate of interest assumed as defined in subparagraph (A) of this paragraph, and

(ii) the means of such reserves,

is to be included as interest paid within the meaning of section 805(e)(1).

Paragraph (6) of the new section 801(g) provides that, for purposes of section 810 (a) and (b) relating to adjustments for decreases and increases in reserves), the sum of the items described in section 810(c) taken into account as of the close of the taxable year is, under regulations prescribed by the Secretary of the Treasury or his delegate, to be adjusted—

(A) by subtracting therefrom an amount equal to the sum of the amounts added from time to time (for the taxable year) to the reserves separately accounted for in accordance with paragraph (3) by reason of appreciation in value of assets (whether or not the assets have been disposed of), and

(B) by adding thereto an amount equal to the sum of the amounts subtracted from time to time (for the taxable year) from such reserves by reason of depreciation in value of assets (whether or not the assets have been disposed of).

The deduction allowable for items described in section 809(d) (1) and (7) with respect to segregated asset accounts is to be reduced to the extent that the amount of such items is increased for the taxable year by appreciation (or is to be increased to the extent that the amount of such items is decreased for the taxable year by depreciation) not reflected in adjustments under the preceeding sentence.

Paragraph (7) of the new section 801(g) provides that, in the case of contracts described in section 805(d)(1) (A), (B), (C), or (D) (relating to the definition of pension plan reserves), the basis of each asset in a segregated asset account shall (in addition to all other adjustments to basis) be increased by the amount of any appreciation in value, and decreased by the amount of any depreciation in value; but only to the extent that such appreciation and depreciation are reflected in the increases and decreases in reserves, or other items described in paragraph (6), with respect to such contracts. The effect of this paragraph is to provide that there shall be no capital gains tax payable by the company on appreciation realized on assets to the extent such application has been reflected in reserves for qualified and certain other pension plan contracts based on segregated asset accounts.

Paragraph (8) of the new section 801(g) provides that, under regulations prescribed by the Secretary of the Treasury or delegate, such additional separate computations (with respect to the items separately accounted for in accordance with par. (3)) are to be made as may be necessary to carry out the purposes of the new subsection (g) and part I of subchapter L.

(b) *Tax in case of capital gains.*—Subsection (b) of section 3 of the bill amends sections 802(a)(2), 804(a)(2), 809(b) (1) and (2), 815(c)(3)(B), and 6501(c)(6) of the Internal Revenue Code of 1954. In general, these amendments relate to the treatment of the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss.

Paragraph (1) amends section 802(a)(2) (relating to tax in case of capital gains) so as to provide that, if for any taxable year beginning after December 31, 1961, the net long-term capital gain (as defined in sec. 1222(7)) of any life insurance company exceeds the net short-term capital loss (as defined in sec. 1222(6)), then, in lieu of the tax imposed by section 802(a)(1), a tax is imposed (if such tax is less than the tax imposed by sec. 802(a)(1)) which is to consist of the sum of—

(A) a partial tax, computed as provided by section 802(a)(1), on the life insurance company taxable income determined by reducing the taxable investment income, and the gain from operations, by the amount of such excess, and

(B) an amount equal to 25 percent of such excess.

Paragraph (2) amends section 804(a)(2) (relating to definition of taxable investment income) by striking out "equal to the sum" and inserting in lieu thereof "equal to the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss plus the sum." Accordingly, such excess is to be added to the sum of the life insurance company's share of each and every item of investment yield. The amount so determined is then reduced (but not below zero) by the sum of the items prescribed in section 804(a)(2) (A) and (B) in determining the taxable investment income for the taxable year

Paragraph (3) provides that paragraphs (1) and (2) of section 809(b) (1) and (2) (relating to definitions of gain and loss from operations) are each amended by striking out "and" at the end of subparagraph (A), by redesignating subparagraph (B) as subparagraph (C), and by inserting after subparagraph (A) the following new subparagraph:

> (B) the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss; and.

Paragraph (4) provides that sections 815(c)(3)(B) and 6501(c)(6) are each amended by striking out "802(a)(1)" and inserting in lieu thereof "802(a)".

(c) *Limitation on certain deductions.*—Subsection (c) of section 3 of the bill amends section 809(f)(2) (relating to application of limitation on certain deductions) so as to provide that, for taxable years beginning after December 31, 1961, the limitation provided by section 809(f)(1) shall apply first to the amount of the deduction for policyholder dividends under section 809(d)(3), then to the amount of the deduction under section 809(d)(6) with respect to group life, accident, and health insurance contracts, and finally to the amount of the deduction under section 809(d)(5) with respect to certain nonparticipating contracts. In other words, under this amendment, the limitation would operate first to disallow a deduction under section 809(d)(5), then a deduction under section 809(d)(6), and finally a deduction under section 809(d)(3). Under existing law, the deduction under section 809(d)(3) would be disallowed first. In applying the 50-percent limitation in section 809(d)(6) in a taxable year beginning after December 31, 1961, the amount of the deductions for taxable years beginning before January 1, 1962, shall be determined by applying the priority of deductions under section 809(f)(2) as in effect prior to this amendment.

(d) *Reduction of policyholders surplus account.*—Subsection (d) of section 3 of the bill adds a new paragraph (5) at the end of section 815(d) (relating to special rules with respect to distributions to shareholders). The new section 815(d)(5) provides that, it—

(1) an amount added to the policyholders surplus account for any taxable year increased (or created) a loss from operations (as defined in sec. 809(b)(2) for such year, and

(2) any portion of the increase in the loss from operations referred to in paragraph (1) did not result in a reduction of any tax under section 802 (relating to tax imposed) for any taxable year to which such loss was carried.

the policyholders surplus account for the last taxable year to which such loss may be carried shall be reduced by the amount described in paragraph (1) or, if lesser, the amount in such account as of the close of such taxable year (computed before any subtractions for such taxable year). The amount of a reduction

under the new section 815(d)(5) is not to be treated as a subtraction from the policyholders surplus account for purposes of sections 815(c)(3) and 802(b)(3).

(e) *Effective date.*—Subsection (e) of section 3 of the bill provides that the amendments made by section 3 of the bill shall apply with respect to taxable years beginning after December 31, 1961.

V. DEPARTMENTAL REPORTS

The report from the Treasury Department received by your committee with respect to this bill is as follows:

TREASURY DEPARTMENT,
Washington, September 7, 1962.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

MY DEAR MR. CHAIRMAN: This is in response to your request for the views of this Department on H.R. 8952. The bill would amend section 4216(b)(2) of the Internal Revenue Code (relating to constructive sale price) to provide that manufacturers or importers of refrigerators; air conditioners; electric, gas, and oil appliances; and radios, television sets, phonographs, and phonograph records may compute excise tax on their sales at retail, or to retailers, on the highest price at which they sell to wholesale distributors. The bill would be applicable to sales on or after January 1, 1962.

Prior to the Excise Tax Technical Changes Act of 1958, effective January 1, 1959, the manufacturers excise taxes under chapter 32 of the code were levied on the actual selling price when a manufacturer sold to retailers. The law, however, provided that when a manufacturer sold at retail the taxable (constructive) price was the price for which such articles were sold in the ordinary course of trade by manufacturers of such articles. This was generally interpreted as the highest wholesale price for which such articles were sold by the manufacturer. If the manufacturer sold to retailers, as well as at retail, his constructive price was his highest price to retailers. If the manufacturer made no sales to retailers, but sold to wholesalers, his constructive price for his sales at retail was his highest price for sales to wholesalers.

The Excise Tax Technical Changes Act of 1958 revised the definition of taxable price for manufacturers' sales at retail to provide that it shall be the lower of the actual price, or the highest price for which such articles are sold to wholesalers in the ordinary course of trade by manufacturers. In addition, the act provided that the taxable price in the case of sales at retail and to retailers could, if certain conditions were met, be the highest price at which the taxable articles were sold to wholesalers by the manufacturer. One of the conditions for use of the latter computation is that sales by manufacturers of the specific type of item are not normally made at retail or to retailers. By "normal" is meant 50 percent or more of all manufacturers' sales of the given type of item.

The Excise Tax Technical Changes Act of 1958 provided for a reduced constructive price on manufacturers' sales to retailers in an attempt to provide more uniformity of taxable price for sales at different levels of distribution. However, the requirement that use of the new constructive price be conditioned on more than 50 percent of the manufacturers' sales of the product not being made at retail and to retailers was inserted on the theory that no significant discrimination existed if it was normal for manufacturers to sell to other than to wholesalers.

The 1958 amendment with respect to sales to retailers has not worked out well. While there is a feeling by all concerned that certain products must fall within the scope of the lower constructive price provision, conclusive data for any given product have yet to be obtained. Normal sources of distribution data are the census of manufactures and trade associations. But differences in classifications of products for trade and tax purposes, and lack of full coverage for a whole industry, have prevented available figures from being sufficient to make a decision as to whether sales to retailers and at retail are, or are not, the normal method of distribution by manufacturers of a given product.

H.R. 8952 represents a proposal to avoid the problems associated with determining the normal method of distribution by doing away with the need for such proof. It presumes that the products mentioned therein meet the requirement.

The various technical difficulties involved in effectuating constructive price provisions led the Treasury Department to formally object to the change in this area made by the Excise Tax Technical Changes Act of 1958 when the legislation was under consideration by your committee. The Department also objected to the general principle involved in an attempt to define a "normal" or "equalized" manufacturers' price (hearings before the Committee on Finance on H.R. 7125, 85th Cong., 2d sess., pp. 3 and 4). Quoted below are excerpts from the 1958 objection of the Department:

"The present constructive price provision applies only where manufacturers sell at retail, or at less than arm's length and at less than fair market price. The latter provision, which is not affected by the bill, is to prevent the manufacturer artificially controlling the price being used as a tax base. The provision for adjustment of taxable price of sales at retail recognizes that such situation is not a usual method of doing business by manufacturers and that the retail price tends to be substantially higher than the price at other levels of distribution at which manufacturers sell. Since manufacturers do not make a large proportion of their sales at retail, not a great deal of use is made of this provision.

"Prior to the retail level, manufacturers customarily perform several distribution functions. Manufacturers may sell directly to retailers; to wholesalers who sell to retailers; and to wholesalers who sell to other wholesalers. The same manufacturer may use all three methods. Even where two competing manufacturers sell only to wholsesalers who sell to retailers, there may be considerable differences in the functions of the wholesalers in the two cases. In one case the manufacturer may perform a great deal of advertising and other services for the wholesaler, while in the other the whole burden of distribution may be on the wholesaler. Such differences in the distribution functions carried on by manufacturers obviously can result in different sales prices by manufacturers for comparable products. But in all cases, the sales are made under a customary method of distribution by manufacturers undertaken in a manner designed to give the manufacturers their maximum profits. Thus, while there is an often repeated belief that the normal manufacturer's price is a price to large-volume wholesalers, this is not really the case.

* * * * * * *

"The attempt to define a normal or equalizing price not only has conceptual deficiencies, but also administrative ones. Manufacturer's invoice prices represent actual prices which are shown in the records of taxpayers. An excise tax on the invoice price can be readily determined. However, once a movement away from the use of the invoice price is made, additional complications for taxpayers in complying with the tax and for auditors in reviewing taxpayers' returns are sure to arise. Either taxpayers have to use a formula of some type to adjust sales price, or they have to assume they sold at the price used in another type of transaction. In any case, the question then arises as to whether the formula should be used, whether it was correctly used, or what adjustment should be made if some other type of sales price is substituted; with all the consequent possibility of conflict between taxpayers and the tax auditors."

We believe the objections of the Department in 1958 to an extension of constructive price determination are as valid today as they were then. Consequently, one course of action regarding the problem presented in H.R. 8952 is to return to the policy in existence prior to 1958.

In the event that your committee does not desire to take this course but prefers instead the general approach of present law, we desire to call the committee's attention to certain aspects of the pending bill.

* * * * * * *

SUPPLEMENTARY STATEMENT BY SENATOR PAUL DOUGLAS

No hearings were held on this bill either in the House or in the Senate. It is impossible, therefore, to determine whether or not it is in the public interest. I think this is poor procedure and that therefore this bill probably needs more thorough scrutiny.

We have drifted into loose procedures on these bills rushed through at the end of the session. They have been going through Congress with little examination and this has sometimes had unfortunate results. I believe our Senate procedures should be revised to provide for a more thorough examination of their possible merits and demerits. In the meantime the Senate should in my opinion go slow.

SUPPLEMENTARY STATEMENT BY SENATOR HARRY F. BYRD

The Senate Finance Committee, in formal meeting September 10, 1962, ordered to be reported 11 bills with recommendations that they be considered favorably by the Senate. This bill was among those ordered to be reported at that time.

As a member of the committee, the Senator from Illinois (Mr. Douglas) voted against committee approval of all these bills except one. He voted affirmatively to report only H.R. 12529 which affected his State.

He voted against reporting all other bills before the committee on that date with the statement that he was voting in the negative because public hearings had not been held.

In his supplementary statements on these bills the Senator from Illinois creates the impression—intentional or not—that the Finance Committee is not giving proper and adequate attention to legislation reported to the Senate.

With respect to all of these bills he apparently tries to leave the inference that the committee has drifted into a loose procedure of rushing bills through at the end of the session which he claims produces unfortunate results.

On behalf of the majority of the Senate Finance Committee I want to make it clear to the Senate that, in the case of the bills ordered to be reported by the committee on September 10, 1962—

1. Each of the bills has been passed by the House of Representatives;
2. No request was made for Senate hearings on these bills and this includes the bill for which the Senator from Illinois voted in the affirmative;
3. Each of the bills ordered to be reported except H.R. 12529 in which the Senator from Illinois is interested, was formally approved by the executive agencies having jurisdiction over their administration;
4. The contents of each bill were fully outlined by members of the committee staff, and discussed by members of the committee; and
5. When the committee voted members had full knowledge of the purpose and effects of the proposed legislation.

Momentous matters are referred to the Senate Committee on Finance, including legislation with respect to taxation, tariffs and customs, social security, veterans, etc., and the committee has always been meticulous in exploring the effects of all legislation it recommends.

The current tax bill—H.R. 10650—now in conference is a case in point. More than 200 witnesses were heard on this bill, and the legislation was under committee consideration more than 4 months.

The Senator from Virginia cannot recall that the Senate has rejected a bill recommended by the Senate Finance Committee. It suffices to say that when the need for hearings is indicated, the committee will hold them.

The procedure followed by the committee in consideration of the agenda for the meeting of September 10 involved no departure from committee practice over the 30 years during which I have been a member.

The committee always holds hearings when they are necessary for the enlightenment of the membership, and the procedure of the past, so far as the chairman is concerned, will be continued in the future.

[H.R. 8952] [10]

CONSTRUCTIVE SALE PRICE FOR PURPOSES OF CERTAIN MANUFACTURERS EXCISE TAXES

[Conference Report No. 2542, Eighty-seventh Congress, Second Session]

[October 5, 1962]

Mr. Mills, from the committee of conference, submitted the following conference report to accompany H.R. 8952.

The committee of conference on the disagreeing votes of the two Houses on the amendments of the Senate to the bill (H.R. 8952) to amend the Internal Revenue Code of 1954 with respect to the conditions under which the special constructive sale price rule is to apply for purposes of certain manufacturers

[10] Public Law 87–858, page 206, this Bulletin.

excise taxes, having met, after full and free conference, have agreed to recommend and do recommend to their respective Houses as follows:

That the House recede from its disagreement to the amendment of the Senate to the text of the bill and agree to the same with amendments as follows:

Page 11 of the Senate engrossed amendments, strike out lines 4 to 23, inclusive.

Page 12 Senate engrossed amendments, strike out lines 1 to 16, inclusive, and insert the following:

(d) NEW COMPANIES QUALIFYING FOR 8-YEAR LOSS CARRYOVER.—

(1) IN GENERAL.—Section *812(e)(2)(B) of such Code (relating to nonqualified corporation) is amended by adding immediately after the words "with any other corporation" in the first sentence, the following: "(except a corporation taxable under part II or part III of this subchapter)".*

(2) EFFECTIVE DATE.—*The amendment made by paragraph (1) shall apply with respect to all taxable years beginning after December 31, 1954, except that in the case of a nonqualified corporation, as defined in section 812(e)(2)(B) of the Internal Revenue Code of 1954 as in effect prior to the amendment made by paragraph (1), a loss from operations for a taxable year beginning in 1955 shall not be an operations loss carryover to the year 1961, and there shall be no reduction in the portion of such loss from operations which may be carried to 1962 or 1963 by reason of an offset with respect to the year 1961.*

Page 12, line 17, of the Senate engrossed amendments, strike out "(f)" and insert the following:

(e) CERTAIN DISTRIBUTIONS OF STOCK OF SUBSIDIARIES.—

Page 13, line 3, of the Senate engrossed amendments, strike out "(g) EFFECTIVE DATE.—The" and insert the following:

(f) EFFECTIVE DATE.—*Except as provided in subsection (d)(2), the*

And the Senate agree to the same.

That the House recede from its disagreement to the amendment of the Senate to the title of the bill and agree to the same.

W. D. MILLS,
CECIL R. KING,
HALE BOGGS,
NOAH MASON,
JOHN W. BYRNES,
Managers on the Part of the House.
HARRY F. BYRD,
ROBT. S. KERR,
RUSSELL LONG,
JOHN J. WILLIAMS,
CARL T. CURTIS,
Managers on the Part of the Senate.

STATEMENT OF THE MANAGERS ON THE PART OF THE HOUSE

The managers on the part of the House at the conference on the disagreeing votes of the two Houses on the amendments of the Senate to the bill (H.R. 8952) to amend the Internal Revenue Code of 1954 with respect to the conditions under which the special constructive sale price rule is to apply for purposes of certain manufacturers excise taxes, submit the following statement in explanation of the effect of the action agreed upon by the conferees and recommended in the accompanying conference report:

SECTION 1. CONSTRUCTIVE SALES PRICE FOR PURPOSES OF CERTAIN MANUFACTURERS EXCISE TAXES

Section 4216(b)(2) of the code now provides that, in determining the base for the computation of manufacturers excise taxes, a constructive sales price may be used where sales are made to retailers or to consumers if sales are also made at the wholesale level. However, this provision applies only if the normal method of sales within the industry is not to sell articles at retail, to retailers, or both. The bill as passed by the House provided that this latter restriction, was not to apply in the case of the manufacturers excise taxes on refrigerators and related items, on electric, gas and oil appliances, and on radios and television sets and related items. Under the Senate amendment to the text of the

bill, and under the conference agreement, this latter restriction is not to apply in the case of any of the manufacturers excise taxes except those relating to automobiles, trucks and buses, business machines, and matches.

Under the bill as passed by the House, this provision would have applied to sales after December 31, 1961. Under the Senate amendment to the text of the bill, and under the conference agreement, this provision will apply to articles sold on or after October 1, 1962.

SECTION 2. CONTRIBUTIONS TO FOUNDATIONS FOR CERTAIN STATE COLLEGES

The Senate amendment to the text of the bill amends section 170(b)(1)(A) of the 1954 Code (relating to limitation on the amount of the deduction for charitable contributions by individuals) to add a new clause (iv). Existing section 170(b)(1)(A) provides for an additional allowance (not to exceed 10 percent of an individual's adjusted gross income) above the general 20-percent limitation for charitable contributions. Under existing law this additional 10-percent limitation is applicable in the case of contributions to churches and conventions or associations of churches, and to certain schools, hospitals, and medical research organizations. The effect of the Senate amendment to the text of the bill, and of the conference agreement, is to make the additional 10-percent provision applicable also in the case of contributions to an organization referred to in section 503(b)(3) of the code which is organized and operated exclusively to receive, hold, invest, and administer property and to make expenditures to or for the benefit of a college or university which is an organization referred to in clause (ii) of section 170(b)(1)(A) and which is an agency or instrumentality of a State or political subdivision thereof, or which is owned or operated by a State or political subdivision thereof or by an agency or instrumentality of one or more States or political subdivisions.

SECTION 3. LIFE INSURANCE COMPANIES

(a) Variable Annuities and Other Segregated Asset Accounts.—The Senate amendment to the text of the bill, and the conference agreement, amend section 801(g) of the 1954 Code, relating to variable annuity contracts—

(1) to remove the termination provisions contained in existing paragraph (6) of subsection (g) of section 801 (which provides that such subsection (g) is not to apply to taxable years beginning after December 31, 1962),

(2) to provide for separate accounting by life insurance companies with respect to contracts with reserves based on segregated asset accounts, and to define such a contract as one—

(A) which provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company.

(B) which provides for the payment of annuities, and

(C) under which the amounts paid in, or the amounts paid as annuities, reflect the investment return and the market value of the segregated asset account,

(3) to provide, in effect, that income allocated to the contracts described in paragraph (2) is not to be taxed to the life insurance company, and

(4) to provide, in effect, that, in the case of qualified pension contracts for which segregated asset accounts are maintained, capital gains allocated to such contracts are not to be taxed to the life insurance company.

(b) Tax in Case of Capital Gains.—Under existing law, a life insurance company is taxed separately on its capital gains. The excess of net long-term capital gains over net short-term capital losses is taxed at a 25 percent rate without the alternative provided other corporations to include capital gains in the regular tax base.

The Senate amendment to the text of the bill, and the conference agreement, provide that a life insurance company is to determine its tax as the lesser of the taxes computed under two methods—a regular method and an alternative method. The regular method requires that the excess of the net long-term capital gain over the net short-term capital loss be included, in effect, in life insurance company taxable income. Under this method, such excess is not taken into account in determining investment yield. The alternative method

requires that the tax be determined by adding 25 percent of such excess to the partial tax computed on the life insurance company taxable income determined without such excess. The alternative method is the one required under present law. This provision applies to taxable years beginning after December 31, 1961.

(c) LIMITATION ON CERTAIN DEDUCTIONS.—Section 809(f)(1) of existing law limits the aggregate amount of deductions allowed to life insurance companies under paragraphs (3), (5), and (6) of section 809(d). Section 809(f)(2) imposes a priority for the application of this limitation to the three deductions. The deductions under such paragraphs (5) and (6), to the extent allowed after the application of this limitation, are added to the policyholders surplus account under subparagraphs (B) and (C) of section 815(c)(2).

The Senate amendment to the text of the bill, and the conference agreement, amend section 809(f)(2) to provide that the limitation of section 809(f)(1) is to apply first to the deduction for dividends to policyholders, then to the special deduction relating to group life insurance contracts and to accident and health insurance contracts, and finally to the special deduction relating to nonparticipating contracts. In a case where the limitation would permit the first of these deductions but not the latter two, then the latter two would not have to be added to the policyholders surplus account. This provision applies to taxable years beginning after December 31, 1961.

(d) REDUCTION OF POLICYHOLDERS SURPLUS ACCOUNT.—Subparagraphs (B) and (C) of section 815(c)(2) of existing law require the addition to the policyholders surplus account of the amount equal to the amounts which have been allowed as deductions under paragraphs (5) and (6) of section 809(d). Under certain circumstances distributions to stockholders by a life insurance company, when it has amounts in the policyholders surplus account, may result in tax to the company.

The Senate amendment to the text of the bill provided that, to the extent that the deductions added to the policyholders surplus account under the indicated subparagraphs, merely increased a loss from operations which did not result in a reduction in tax for any taxable year to which the loss could be carried, then such additions may be removed from the policyholders surplus account without incurring tax liability.

The conference agreement does not include this provision.

(e) NEW COMPANIES QUALIFING FOR 8-YEAR LOSS CARRYOVER.—Under existing law certain new insurance companies, which are not controlled by another corporation, or which do not control another corporation, may carry over operations losses for 8 years.

The Senate amendment to the text of the bill, and the conference agreement, provide that the disqualification from the 8-year operations loss carryover will not apply where the new life insurance company is connected through stock ownership only with a corporation taxable as an insurance company other than as a life insurance company.

This provision applies to all losses to which the Life Insurance Company Tax Act of 1959 would have applied, if it had originally contained this provision, except that a loss arising in 1955 shall not by reason of this amendment be an operations loss carryover to 1961 and there shall be no reduction in the amount of such a loss which may be carried to 1962 or 1963 by reason of an offset for 1961.

(f) CERTAIN DISTRIBUTIONS OF STOCK OF SUBSIDIARIES.—Under section 815(a) of existing law a life insurance company is, under certain circumstances, subject to tax at the time of distributions of property to stockholders.

The Senate amendment to the text of the bill, and the conference agreement, provide that after December 31, 1961, and before January 1, 1964, section 815(a) will not apply to a distribution of stock of a controlled corporation, if (1) the distribution meets the requirements for a tax-free distribution under section 355, (2) the controlled corporation is an insurance company subject to tax under section 831 (relating to tax on certain insurance companies other than life and certain mutuals), and (3) control was acquired before January 1, 1963, in a stock-for-stock transaction qualifying as a reorganization under section 368 (a) (1) (B).

W. D. MILLS,
CECIL R. KING,
HALE BOGGS,
NOAH MASON,
JOHN W. BYRNES,
Managers on the Part of the House.

[H.R. 5260] [11]

MAKING PERMANENT EXISTING SUSPENSIONS OF TAX ON THE FIRST DOMESTIC PROCESSING OF COCONUT OIL AND PALM OIL

[House of Representatives Report No. 2239, Eighty-seventh Congress, Second Session]

[August 16, 1962]

Mr. MILLS, from the Committee on Ways and Means, submitted the following report to accompany H.R. 5260.

The Committee on Ways and Means, to whom was referred the bill (H.R. 5260) to repeal the 3 cents per pound processing tax on coconut oil, and for other purposes, having considered the same, report favorably thereon with amendments and recommend that the bill as amended, do pass.

The amendments are as follows:

Strike out all after the enacting clause and insert in lieu thereof the following: That subsection (a) of section 4511 of the Internal Revenue Code of 1954 (relating to tax on first domestic processing of coconut and palm oil) is hereby repealed.

TECHNICAL AMENDMENTS

SEC. 2. (a) Section 4511(b) of the Internal Revenue Code of 1954 (relating to additional rate on coconut oil) is amended—

(1) by striking out "ADDITIONAL" in the heading and

(2) by striking out "(in addition to the tax imposed by the preceding subsection)".

(b) Section 4511(c) of such Code (relating to termination of additional rate) is amended by striking out "ADDITIONAL RATE" in the heading and inserting in lieu thereof "TAX ON COCONUT OIL".

(c) Section 4513(b) of such Code (relating to exemptions from additional tax on coconut oil) is amended—

(1) by striking out "ADDITIONAL" in the heading, and

(2) by striking out "additional" each place it appears in the text.

EFFECTIVE DATE

SEC. 3. The amendments made by this Act shall take effect on the date of the enactment of this Act.

Amend the title so as to read:

A bill to make permanent the existing suspensions of the tax on the first domestic processing of coconut oil, palm oil, palm kernel oil, and fatty acids, salts, and combinations or mixtures thereof.

PURPOSE

The purpose of H.R. 5260, as amended by the Committee on Ways and Means, is to repeal the processing tax imposed by section 4511(a) of the Internal Revenue Code of 1954 on the first domestic processing of coconut oil, palm oil, palm-kernel oil and certain derivatives of such oils.

GENERAL STATEMENT

Section 4511(a) of the Internal Revenue Code of 1954 provides as follows:

> There is hereby imposed upon the first domestic processing of coconut oil, palm oil, palm-kernel oil, fatty acids derived from any of the foregoing oils, salts of any of the foregoing (whether or not such oils, fatty acids, or salts have been refined, sulphonated, sulphated, hydrogenated, or otherwise processed), or any combination or mixture containing a substantial quantity of any one or more of such oils, fatty acids, or salts, a tax of 3 cents per pound, to be paid by the processor.

The tax on the first domestic processing of coconut oil has been suspended continuously since October 1, 1957, while that applicable to the first domestic processing of palm oil and palm-kernel oil has been suspended since July 1, 1959.

[11] Public Law 87–859, page 210, this Bulletin.

The Tariff Commission report on this bill reads in pertinent part as follows:

> Coconut oil and palm-kernel oil are the only commercially important lauric-acid oils now used in the United States. The domestic processing taxes on these oils provided for in IRC subsection 4511(a) were originally imposed in 1934, principally to protect domestically produced edible fats and oils in uses which coconut oil is at present of little importance, such as in margarine. Although very little palm-kernel oil was used in margarine or shortening, it was subjected to the tax presumably because it could be substituted for coconut oil. Coconut oil is currently important in the manufacture of soap because of the superior lathering properties which the oils impart. Palm-kernel oil is used in the United States principally in edible products such as biscuits, crackers, and confectionery. Neither of the oils is made from materials produced in the United States. The principal use of palm oil in the United States is in the tinplate industries where it serves to prevent oxidation in the plating baths. Imports for this use have been exempt from the tax since 1942.

The Tariff Commission further advised your committee that it has not received any complaints regarding the suspension of the processing taxes on the products covered by this bill. Favorable reports were received from the Departments of Agriculture, Commerce, and State.

Your committee believes that the history of the temporary suspension of these processing taxes demonstrates that their permanent removal will be in the interest of the users of these oils and there will be no adverse effect on any segment of the U.S. economy.

The Committee on Ways and Means is unanimous in recommending the enactment of H.R. 5260, as amended by the committee.

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[H.R. 5260] [12]

COCONUT AND PALM OILS

[Senate Report No. 2102, Eighty-seventh Congress, Second Session, Calendar No. 2068]

[September 18, 1962]

Mr. Byrd of Virginia, from the Committee on Finance, submitted the following report together with supplemental views to accompany H.R. 5260.

The Committee on Finance, to whom was referred the bill (H.R. 5260) to make permanent the existing suspensions of the tax on the first domestic processing of coconut oil, palm oil, palm-kernel oil, and fatty acids, salts, and combinations or mixtures thereof, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

I. SUMMARY OF BILL

H.R. 5260 as passed by the House would repeal the processing tax on the first domestic processing of coconut oil, palm oil, palm-kernel oil, and certain derivatives of such oils. Your committee has amended this bill to suspend this tax for 3 more years (until June 30, 1966) rather than repeal it.

II. GENERAL STATEMENT

Present law (sec. 4511(a) of the code) provides for the imposition of a tax of 3 cents a pound upon the first domestic processing of—

> coconut oil, palm oil, palm-kernel oil, fatty acids derived from any of the foregoing oils, salts of any of the foregoing (whether or not such oils, fatty acids, or salts have been refined, sulphonated, sulphated,

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[12] Public Law 87–859, page 210, this Bulletin.

hydrogenated, or otherwise processed), or any combination or mixture containing a substantial quantity of any one or more of such oils, fatty acids, or salts.

The tax on the first domestic processing of coconut oil has been suspended continuously from October 1, 1957, to June 30, 1963, while the tax on the first domestic processing of palm oil and palm-kernel oil has been suspended continuously from July 1, 1959, to June 30, 1963. This latter suspension was designed to restore the competitive balance between these oils and competing coconut and babassu oils on which the processing tax had already been suspended. The House bill would have repealed these processing taxes, while the bill as amended by your committee suspends these taxes for an additional 3 years, or until June 30, 1956.

Coconut oil and palm-kernel oil are the only commercially important lauric acid oils now used in the United States. The domestic processing taxes on these oils provided for in section 4511(a) of the Internal Revenue Code of 1954, as amended, were originally imposed in 1934, principally to protect domestically produced edible fats and oils in uses in which coconut oil is at present of little importance, such as in margarine. Although very little palm-kernel oil was used in margarine or shortening, it was subjected to the tax presumably because it could be substituted for coconut oil. Coconut oil is currently important in the manufacture of soap because of the superior lathering properties which the oils impart. Palm-kernel oil is used in the United States principally in edible products such as biscuits, crackers, and confectionery. Neither of the oils is made from materials produced in the United States. The principal use of palm oil in the United States is in the tinplate industries where it serves to prevent oxidation in the plating baths. Imports for this use have been exempt from the tax since 1942.

The Tariff Commission advised your committee that it has not received any complaints regarding the suspension of the processing taxes on the products covered by this bill. Favorable reports were received from the Departments of Agriculture, Commerce, and State.

Your committee has found no objection to the further suspension of these processing taxes although questions have been raised as to their repeal. In view of this your committee has amended the House bill to provide for a further 3-year suspension of these taxes.

III. DEPARTMENTAL REPORTS

The following reports on this bill were submitted by the Departments of Commerce, Treasury, Agriculture, and the Bureau of the Budget. The analysis submitted by the U.S. Tariff Commission is also printed below for the information of the Senate.

THE SECRETARY OF COMMERCE,
Washington, D.C., August 23, 1962.

HON. WILBUR D. MILLS,
Chairman, Committee on Ways and Means,
House of Representatives,
Washington, D.C.

DEAR MR. CHAIRMAN: This is in further reply to your request for the views of this Department with respect to H.R. 7830, a bill to make permanent the existing suspensions of the tax on the first domestic processing of coconut oil, palm oil, palm-kernel oil, and fatty acids, salts, combinations or mixtures thereof.

The Department favors the enactment of this legislation.

Coconut oil, palm-kernel oil, and palm oil are imported for certain uses in edible and inedible products because of their special properties. The raw materials from which these oils are obtained are not grown commercially in the United States.

Coconut oil is used in the manufacture of bakery products and confectionery products as well as in soap, lubricants and similar oils, insecticides and germicides, resins, pharmaceuticals, toilet articles, textile auxiliaries, plasticizers, detergents, hydraulic brake fluids, and synthetic rubber. Over half the current consumption of coconut oil is used in edible products. Palm-kernel oil is used primarily in bakery products and confectionery products, in fat splitting, hydrogenation, and other industrial processing.

The principal use of palm oil in the United States is in the manufacture of steel products such as tinplate and terneplate. Imports for this use, by law, have been exempt from payment of the processing tax. A small quantity of palm oil is used in making soap and in other industrial products.

United States is an exporter of fats and oils and therefore protection of domestic producers of fats and oils through imposition of the processing tax is unnecessary.

The Bureau of the Budget advised there would be no objection to the submission of this report from the standpoint of the administration's program.

Sincerely yours,

EDWARD GUDEMAN,
Under Secretary of Commerce.

THE GENERAL COUNSEL OF THE TREASURY,
Washington, September 11, 1962.

HON. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: Reference is made to your request for the views of this Department on H.R. 5260, to make permanent the existing suspensions of the tax on the first domestic processing of coconut oil, palm oil, palm-kernel oil, and fatty acids, salts, and combinations or mixtures thereof.

The proposed legislation would repeal subsection (a) of section 4511 of the Internal Revenue Code which imposes a tax of 3 cents per pound on the first domestic processing of coconut oil, palm oil, palm-kernel oil, fatty acids derived therefrom, or salts thereof, or any combination or mixture containing a substantial quantity of one or more of such oils, fatty acids, or salts. At the present time this tax has been suspended temporarily until June 30, 1963, by Public Law 86–432.[13]

The Treasury Department has no comments to make on the general merits of the proposed legislation. For the information of your committee, it is expected that the annual loss of revenue resulting from the repeal of subsection (a) of section 4511 of the Internal Revenue Code may approximate $16 million.

The Department was advised by the Bureau of the Budget that there was no objection from the standpoint of the administration's program to the submission of a similar report to the Committee on Ways and Means on H.R. 7830, an identical bill.

Sincerely yours,

FRED B. SMITH,
Acting General Counsel.

DEPARTMENT OF AGRICULTURE,
Washington, D.C., February 28, 1962.

HON. WILBUR D. MILLS,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: We wrote you on September 1, 1961, in response to the request of your committee for the Department's views and recommendations on bills H.R. 5979 and H.R. 7830 introduced by Congressman King of California and Congressman Keogh of New York, respectively. These bills propose to eliminate permanently the 3 cents per pound processing tax on coconut oil, palm oil, palm-kernel oil, and their fatty acids and salts.

After further evaluation of the facts involved in the removal of this processing tax and consultation with the industries involved, we now wish to restate our position. We do not now oppose the permanent removal of this tax. The enactment of this legislation at the present time appears to be necessary for the advancement and development of research on the technical aspects of the utilization of both domestic and imported vegetable oils and domestic animal fats by the U.S. soap and fatty acids industries. This position takes into consideration the extensive research that is now being undertaken on petroleum-based synthetic detergents which can replace and have replaced a considerable volume

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[13] C.B. 1960–1, 792.

of fats and oils used by the U.S. detergent industry. Current and anticipated research on improving synthetic petroleum detergents may adversely affect future consumption of fats and oils produced in the United States more than we had thought possible.

The Bureau of the Budget advises that there is no objection to the presentation of this report from the standpoint of the administration's program.

Sincerely yours,

ORVILLE FREEMAN, *Secretary.*

DEPARTMENT OF AGRICULTURE,
Washington, D.C., September 1, 1961.

Hon. WILBUR D. MILLS,
Chairman, Committee on Ways and Means,
House of Representatives.

DEAR MR. MILLS: This is in response to the request of your committee for this Department's views and recommendations with respect to bills H.R. 5979 and H.R. 7830, introduced by Congressman King of California and Congressman Keogh of New York, respectively. The first-referenced bill proposes to eliminate permanently the 3 cent per pound processing tax on coconut oil, its fatty acids and salts. The latter-referenced bill would do likewise and, in addition, would remove permanently the tax on the first domestic processing of palm oil, palm-kernel oil, and their fatty acids and salts, combinations or mixtures thereof.

We believe that the enactment of this legislation at this time is unnecessary. The 3 cents per pound tax, applicable to each of the foregoing items, is suspended through June 30, 1963, under the provisions of Public Law 86–432, approved April 22, 1960. Under this law the processing tax is not to be reimposed before another 2 years. We consider it premature, therefore, to consider new legislation which would remove the tax permanently.

This Department announced several months ago new and higher price supports for soybeans and cottonseed. As a consequence of this, and the adoption of a program causing a cutback in the production of feed grains, a record outturn of oilseeds in 1961 may be expected. As of August 1 the soybean crop was estimated at 683 million bushels, 18 percent higher than the previous record crop of 1958.

Increased imports of palm products, in view of the increased domestic production of oilseeds, might create a situation in which it would be necessary to reimpose the tax on the palm oils. We should like, therefore, the opportunity to observe the situation during the next 2 years, before recommending legislation which would remove permanently the tax on the palm oils and their products.

The Bureau of the Budget advises that there is no objection to the presentation of this report from the standpoint of the administration's program.

Sincerely,

ORVILLE FREEMAN, *Secretary.*

U.S. TARIFF COMMISSION,
Washington, D.C., July 17, 1961.

Hon. WILBUR D. MILLS,
Chairman, Committee on Ways and Means,
House of Representatives.

DEAR MR. CHAIRMAN: This is in response to your request of June 26, 1961, for a report on H.R. 7830 of the 87th Congress, a bill to make permanent the existing suspensions of the tax on the first domestic processing of coconut oil, palm oil, palm-kernel oil, and fatty acids, salts, combinations or mixtures thereof.

H.R. 7830, if enacted, would amend sections 4511 and 4513 of the Internal Revenue Code of 1954 so as to repeal the 3 cents per pound processing tax applicable to coconut oil, palm oil, palm-kernel oil, fatty acids derived therefrom, salts thereof, or any combination or mixture solely because such combination or mixture contains a substantial quantity of such oil, fatty acid, or salts. Subsection 4511(a), Internal Revenue Code, provides as follows:

"There is hereby imposed upon the first domestic processing of coconut oil, palm oil, palm-kernel oil, fatty acids derived from any of the foregoing oils, salts of any of the foregoing (whether or not such oils, fatty acids, or salts have been refined, sulphonated, sulphated, hydrogenated, or otherwise processed),

or any combination or mixture containing a substantial quantity of any one or more of such oils, fatty acids, or salts, a tax of 3 cents per pound, to be paid by the processor."

Currently there are two taxes applicable upon the first domestic processing of coconut oil, a "general" tax of 3 cents per pound under subsection 4511(a) which would be repealed by the bill, and an "additional" tax of 2 cents per pound under IRC subsection 4511(b) which would not be disturbed by the bill. The 2 cents per pound tax is not applicable to Philippine coconut oil, articles containing such oil, or oil produced from Philippine coconuts. Under the U.S. trade agreement with the Philippines, the United States is bound not to reduce this 2 cents per pound preference unless Philippine oil and copra are in short supply in the United States.

Coconut oil and palm-kernel oil are the only commercially important lauric acid oils now used in the United States. The domestic processing taxes on these oils provided for in IRC subsection 4511(a) were originally imposed in 1934, principally to protect domestically produced edible fats and oils in uses in which coconut oil is at present of little importance, such as in margarine. Although very little palm-kernel oil was used in margarine or shortening, it was subjected to the tax presumably because it could be substituted for coconut oil. Coconut oil is currently important in the manufacture of soap because of the superior lathering properties which the oils impart. Palm-kernel oil is used in the United States principally in edible products such as biscuits, crackers, and confectionery. Neither of the oils is made from materials produced in the United States. The principal use of palm oil in the United States is in the tinplate industries where it serves to prevent oxidation in the plating baths. Imports for this use have been exempt from the tax since 1942.

H.R. 3796 of the 85th Congress proposed to repeal the 3 cents per pound processing tax on coconut oil. However, a provision for the suspension of the tax until July 1, 1960, only was included as section 3 of Public Law 85–235, approved August 30, 1957.[14] The tax on palm oil and palm-kernel oil was also suspended until July 1, 1960, by Public Law 86–37, approved May 29, 1959.[15] The reason for the suspension of the tax on the latter oils was that the suspension of the tax on coconut oil placed palm oil and palm-kernel oil at a competitive disadvantage, since such oils are used for the same general purposes as coconut oil and babassu oil (babassu oil was never made subject to tax). These suspensions of the tax were extended until the close of June 30, 1963, by Public Law 86–432, approved April 22, 1960.[16] The Commission has not received any complaints regarding the suspension of the processing taxes on these products.

There are several technical amendments to the bill which the committee may wish to consider. First, the bill would amend IRC section 4511 in such a manner that it would have subsections (b) and (c) but no subsection (a). This disparity could be corrected by redesignating the subsections and by changing the references thereto in subsections 4511(c) and 4513(b). Secondly, all of the text appearing after the word "imposed" in IRC section 4512 should be deleted because it would become obsolete by the enactment of the bill. Third, a close parenthesis should be inserted after "oil" in line 10, page 2, of the bill.

By direction of the Commission:

Sincerely yours,

Donn N. Bent, *Secretary.*

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SUPPLEMENTARY STATEMENT BY SENATOR PAUL DOUGLAS

No hearings were held on this bill either in the House or in the Senate. It is impossible, therefore, to determine whether or not it is in the public interest. I think this is poor procedure and that therefore this bill probably needs more thorough scrutiny.

We have drifted into loose procedures on these bills rushed through at the end of the session. They have been going through Congress with little examination and this has sometimes had unfortunate results. I believe our Senate procedures should be revised to provide for a more thorough examination of their possible merits and demerits. In the meantime the Senate should in my opinion go slow.

[14] C.B. 1957–2, 1061.
[15] C.B. 1959–2, 654.
[16] C.B. 1960–1, 792.

SUPPLEMENTARY STATEMENT BY SENATOR HARRY F. BYRD

The Senate Finance Committee, in formal meeting September 10, 1962, ordered to be reported 11 bills with recommendations that they be considered favorably by the Senate. This bill was among those ordered to be reported at that time.

As a member of the committee, the Senator from Illinois (Mr. Douglas) voted against committee approval of all of these bills except one. He voted affirmatively to report only H.R. 12529 which affected his State.

He voted against reporting all other bills before the committee on that date with the statement that he was voting in the negative because public hearings had not been held.

In his supplementary statements on these bills the Senator from Illinois creates the impression—intentional or not—that the Finance Committee is not giving proper and adequate attention to legislation reported to the Senate.

With respect to all of these bills he apparently tries to leave the inference that the committee has drifted into a loose procedure of rushing bills through at the end of the session, which he claims produces unfortunate results.

On behalf of the majority of the Senate Finance Committee I want to make it clear to the Senate that, in the case of the bills ordered to be reported by the committee on September 10, 1962—

1. Each of the bills has been passed by the House of Representatives;
2. No request was made for Senate hearings on these bills and this includes the bill for which the Senator from Illinois voted in the affirmative;
3. Each of the bills ordered to be reported, except H.R. 12529 in which the Senator from Illinois is interested, was formally approved by the executive agencies having jurisdiction over their administration;
4. The contents of each bill were fully outlined by members of the committee staff, and discussed by members of the committee; and
5. When the committee voted, members had full knowledge of the purpose and effects of the proposed legislation.

Momentous matters are referred to the Senate Committee on Finance, including legislation with respect to taxation, tariffs and customs, social security, veterans, etc., and the committee has always been meticulous in exploring the effects of all legislation it recommends.

The current tax bill—H.R. 10650—now in conference is a case in point. More than 200 witnesses were heard on this bill, and the legislation was under committee consideration more than 4 months.

The Senator from Virginia cannot recall that the Senate has rejected a bill recommended by the Senate Finance Committee. It suffices to say that when the need for hearings is indicated, the committee will hold them.

The procedure followed by the committee in consideration of the agenda for the meeting of September 10 involved no departure from committee practice over the 30 years during which I have been a member.

The committee always holds hearings when they are necessary for the enlightenment of the membership, and the procedure of the past, so far as the chairman is concerned, will be continued in the future.

[H.R. 2016][17]

PROVIDING THAT ONLY ONE RETAIL LIQUOR DEALER TAX NEED BE PAID BY ANY STATE AND POLITICAL SUBDIVISION OPERATING LIQUOR STORES

[House Report No. 1254, Eighty-seventh Congress, First Session]

[September 22, 1961]

Mr. Green of Pennsylvania, from the Committee on Ways and Means, submitted the following report to accompany H.R. 2016.

The Committee on Ways and Means, to whom was referred the bill (H.R. 2016) to provide that States and political subdivisions which operate liquor stores shall

[17] The provisions of H.R. 2016 were incorporated in H.R. 10620, passed as Public Law 87–863, page 210, this Bulletin.

not be required to pay more than one tax as a retail dealer in liquor, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments are as follows:

Page 2, line 13, strike out "District." " and insert "District","

Page 2, line 15, strike out "1961" and insert "1962".

I. SUMMARY OF BILL

This bill provides that States and political subdivisions which operate retail liquor stores are to be required to pay only one $54 retail liquor dealer occupational tax each year instead of paying a separate $54 tax for each store location. This bill as amended is to apply as of July 1, 1962.

This bill has been reported unanimously by your committee.

II. GENERAL STATEMENT

Under present law (sec. 5121) retail dealers in liquor are required to pay an annual special occupational tax of $54 for each location in which they carry on their business. This tax presently applies to State and local government stores as well as to those which are privately owned.

It is understood that there now are 16 States in which retail liquor stores are operated by State governments as well as 2 others where they are operated by county governments. Current statistics with respect to the costs of the Federal retail liquor dealer taxes in these States suggest that the revenue involved is approximately $120,000 a year.

Your committee recognizes that States and political subdivisions in operating retail liquor stores are performing a proprietary function and, therefore, can be required to pay this special tax as retail liquor dealers with respect to each store location. (See, for example, *Ohio* v. *Helvering*, 292 U.S. 360 (1934), and *South Carolina* v. *U.S.*, 199 U.S. 437 (1905).) Nevertheless, the reason for imposing a separate tax in the case of private retail liquor dealers with respect to each location is to prevent discrimination in favor of those dealers with multiple locations. Since when governmental units operate retail liquor stores the stores are almost always operated on a noncompetitive or monopoly basis, the collection of a separate tax with respect to each location is not necessary in order to prevent competitive discrimination in the case of these governmentally operated liquor stores. Moreover, your committee sees no reason why in such cases State and local governmental revenues should be less than they otherwise would be because of the imposition of any significant amount of tax by the Federal Government. In addition, there is the fact that when, for example, military posts exchanges, sell liquor, they frequently are not subject to State or local governmental licensing taxes.

In view of these considerations your committee has provided (in sec. 5123(b)) that the special occupational tax of $54 a year imposed with respect to retail dealers in liquor (by sec. 5121(a)) is to apply only once with respect to a State or political subdivision or the District of Columbia regardless of the number of locations at which the liquor is sold.

It is intended that the retail liquor dealer stamp denoting payment of the tax, and which is now required (by sec. 6806) to be posted in each State or local government liquor store, is under this provision to be posted at the principal place of business of the State, county, or municipal store system (as the case may be).

The bill also makes conforming changes (in sec. 5113(b)) as well as deleting obsolete references to "Territory."

The bill as amended is to take effect on July 1, 1962, the due date for the retail liquor dealer occupational taxes for the year July 1, 1962, to June 30, 1963.

[H.R. 10117] [18]

INCLUSION OF MEDICAL, ETC., BENEFITS UNDER QUALIFIED PENSION PLANS

[House Report No. 2317, Eighty-seventh Congress, Second Session]

[August 31, 1962]

Mr. Mills, from the Committee on Ways and Means, submitted the following report to accompany H.R. 10117.

The Committee on Ways and Means, to whom was referred the bill (H.R. 10117) to amend section 401 of the Internal Revenue Code of 1954 to provide that plans which provide certain medical and other benefits for retired employees and their families may be qualified pension plans, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

The amendment is as follows:

Strike out all after the enacting clause and insert:

That section 401 of the Internal Revenue Code of 1954 (relating to qualified pension, profit-sharing, and stock bonus plans) is amended by redesignating subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:

(c) Medical, Etc., Benefits for Retired Employees and Their Spouses and Dependents.—Under regulations prescribed by the Secretary or his delegate, a pension plan may provide for the payment of benefits for sickness, accident, hospitalization, and medical expenses of retired employees, their spouses, and their dependents, but only if—

(1) such benefits are subordinate to the retirement benefits provided by the plan,

(2) a separate account is established and maintained for such benefits,

(3) the employer's contributions to such separate account are reasonable and ascertainable,

(4) it is impossible, at any time prior to the satisfaction of all liabilities under the plan to provide such benefits, for any part of the corpus or income of such separate account to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of such benefits, and

(5) notwithstanding the provisions of subsection (a)(2), upon the satisfaction of all liabilities under the plan to provide such benefits, any amount remaining in such separate account must, under the terms of the trust instrument, be returned to the employer.

Sec. 2. The amendments made by the first section of this Act shall apply to taxable years beginning after the date of the enactment of this Act.

I. GENERAL STATEMENT

H.R. 10117, as amended by your committee, would allow a pension plan, qualified under the Internal Revenue Code of 1954, to provide for the payment of benefits for sickness, accident, hospitalization, and medical expenses of retired employees and their spouses and dependents, if such benefits are subordinate to the retirement benefits provided by the plan. An employer may under present law provide such sickness, accident, hospitalization and medical expense benefits to his retired employees and their families through the use of a separate plan under which the employer would be entitled to a deduction for contributions and the employees would not be treated as having received gross income. Under present law, however, it is impossible for an employer to fund such benefits through a qualified pension plan. This bill would make it possible, where an employer chooses to do so, to provide these benefits through a qualified pension plan rather than being required to do so separately, as under existing law. Thus, the revenue loss would be negligible since the purpose of the bill is essentially to simplify administration of such benefits.

Your committee has amended the bill to provide that where such benefits are included in a pension plan the employer must allocate his total contributions to

[18] The proivsions of H.R. 10117 were incorporated in H.R. 10620, passed in Public Law 87–863, page 210, this Bulletin.

two separate accounts, one being used to fund pension benefits and the other being used to fund medical benefits.

II. REASONS FOR THE BILL

The system of providing for the pension needs of workers through qualified employer pension plans has become an important feature of the American scene. It has also become common to provide medical benefits through employer contributions to an insurance plan for employees. In both situations, under present law, if certain conditions are met, the employer may receive a tax deduction for contributions to a pension plan or to an insurance plan and these contributions are not currently includible in income of the employee in the case of pension plans and are not includible in income at all (subject to the limitation in sec. 105) in the case of medical expense insurance. This tax treatment has had a considerable effect on the growth of both types of plans.

A number of employers have provided, under their sickness and accident policies for employees, a continuation of benefits after the employee retires. Since the employee must earn his entitlement to such benefits during his working years, it is often desirable that the sickness and accident insurance to which an employee will be entitled after retirement be funded during the working years in the same way that the employer might fund the employees' pension rights. From the standpoint of the employer, it may be more efficient to fund the pension and insurance programs together in a single qualified plan in order to reduce administrative expenses. The present language of section 401 of the Internal Revenue Code of 1954, however, has been interpreted as making a pension plan which provides other than pension benefits nonqualified, and thus the employer would lose his deduction for amounts contributed. Various other tax advantages of a qualified pension plan would also be lost. This means that under present law employers must incur the added expenses of setting up a separate fund, with trustees, etc., to provide for the medical expenses of their retired employees.

The bill would make it possible to fund the two programs in a single trust without loss of qualified status for the trust. It is required, however, that the amount of the contributions being used to fund pension benefits and the amount being used to fund medical benefits must be kept separate. The employer contributions to the medical benefit account must be reasonable and ascertainable. No part of the fund maintained to pay medical benefits may be used at any time to pay pension benefits. These requirements are necessary in order to preserve the limitations in section 404 dealing with the amount of the employer pension contribution that may be deductible.

The medical benefits that might be covered for retired employees include sickness, accident, hospitalization, and medical expenses of retired employees, their spouses and dependents. The bill would be effective for taxable years beginning after the date of its enactment.

The Treasury estimates that any revenue loss would be negligible.

The bill was reported unanimously by your committee. The Treasury Department and the Department of Health, Education, and Welfare have indicated that they have no objection to the enactment of the bill as reported.

III. TECHNICAL EXPLANATION

The first section of the bill amends section 401 of the Internal Revenue Code of 1954 by redesignating subsection (c) as subsection (d) and by inserting a new subsection (c). The new subsection (c) sets forth the conditions under which qualified pension plans may provide for the payment of benefits for sickness, accident, hospitalization, and medical expenses (hereinafter referred to as "medical, etc., benefits") of retired employees and their spouses and dependents.

The new subsection (c) applies to any trust or trusts forming a part of a plan which meets the requirements of section 401(a) of the code, and which is established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. Thus, the new subsection (c) applies only to qualified pension plans and does not apply to qualified stock bonus or profit-sharing plans. The new subsection (c) provides that, under regulations to be prescribed by the Secretary of the Treasury or his delegate, a qualified pension plan may provide for the payment of medical, etc., benefits for retired employees, their spouses and their dependents, if, with respect to such benefits,

the plan meets the requirements set forth in paragraphs (1), (2), (3), (4), and (5) of the new subsection (c). Since to qualify under section 401(a) a plan must not discriminate in favor of officers, shareholders, supervisory employees, or other highly compensated employees with respect to coverage and with respect to the contributions or benefits under the plan, the determination of whether or not a pension plan which provides the medical, etc., benefits described in the new subsection (c) satisfies the requirements of section 401(a) of the code shall be made with reference to the retirement portion of the plan as well as the medical, etc., benefit portion of the plan. Thus, for example, a plan will not be qualified under section 401(a) if it discriminates in favor of employees who are officers or shareholders with respect to either portion of the plan. A pension plan which provides the benefits described in the new subsection (c), and which otherwise satisfies the requirements set forth in section 401(a) of the code, will not be considered as a qualified plan unless it also satisfies the requirements of paragraphs (1), (2), (3), (4), and (5) of the new subsection (c). The benefits which may be provided under the new subsection (c) are limited to benefits which are paid with respect to a retired employee, his spouse or dependents because of sickness, accident, hospitalization, or medical expenses. Thus, for example, as under existing law, a qualified pension plan may not provide layoff or unemployment benefits of any kind.

Contributions to provide the benefits described in the new subsection (c) may be made either on a contributory or noncontributory basis, without regard to whether the contributions to fund the retirement benefits are made on a similar basis. Thus, for example, the contributions to fund the medical, etc., benefits allowed under the new subsection (c) may be provided for entirely out of employer contributions even though the retirement benefits under the plan are determined on the basis of both employer and employee contributions.

The deductibility of any contributions made by an employer under a plan to provide the benefits described in the new subsection (c) shall be determined in accordance with the rules contained in section 404 of the code. Thus, such contributions will generally be deductible in full in the year in which the contribution is actually made.

No part of the contributions paid by the employer to provide such benefits will be taxed currently to the employee. However, any payments with respect to such medical, etc., benefits will be subject to tax (to the extent not attributable to employee contributions) under section 402(a) (1) or (2) at the time the payments are made unless such payments are otherwise excluded from gross income. See, e.g., section 101(b) (relating to employees' death benefits) and section 105 (relating to amounts received under accident and health plans). For example, assume a qualified pension plan provides accident and health benefits financed entirely by employer contributions for retired employees, their spouses and their dependents. Assume further that subsequent to his retirement an employee covered under the plan receives $2,000 as full payment for hospital and other medical expenses actually incurred by reason of his sickness. Subject to the limitations of section 105(b) (relating to exclusion from gross income for amounts expended for medical care), the entire $2,000 would be excludable from gross income under such section.

Under the new subsection (c) the term "retired employees" includes an employee who is retired by reason of disability, whether or not such disability is related to the employment or is covered by workmen's compensation or by any other form of insurance. However, the term does not include employees who, although past the age of normal retirement, are not considered to be retired for purposes of the retirement portion of the plan.

The first of the requirements set forth in the new subsection (c) is that the medical, etc., benefits must be subordinate to the retirement benefits provided by the plan. Thus, if it is obvious from all the facts and circumstances that the real purpose of the plan is to provide medical, etc., benefits rather than pension benefits, the plan will not qualify under section 401 of the code. Since the new subsection (c) provides for payments to spouses and dependents of retired employees, a pension plan which otherwise meets the requirements of section 401(a) and the new subsection (c) will not be disqualified merely because the medical, etc., benefit portion includes provision for the payment of death benefits. However, such death benefits when added to the other medical, etc., benefits must be subordinate to the pension benefits provided under the plan.

The second requirement for qualification under the new subsection (c) is that a separate account must be established and maintained for the payment of the medical, etc., benefits. The effect of this provision is to require an employer to allocate his total contributions into two separate accounts, one amount being used to fund his pension benefits and the other amount being used to fund his medical, etc., benefits. This allocation is necessary in order to enable the Commissioner of Internal Revenue to determine whether the actuarial limitations imposed by section 404 of the code on deductions claimed for pension contributions are properly applied.

However, the funds in the accounts may be jointly invested without identification of which securities are allocable to each of the separate accounts.

The third requirement set forth in the new subsection (c) provides that the employer's contributions to fund the medical and other benefits described in the new subsection (c) must be reasonable and ascertainable. Thus, it must be possible under the plan to determine the portion of the employer's contribution which is made to fund the pension benefits and the portion of the contribution made under the plan which is made to fund the medical, etc., benefits. As under existing law, if any portion of the contribution to provide either pension or medical, etc., benefits does not meet the ordinary and necessary tests, the employer will not be permitted to deduct the entire amount of such contribution under section 404 of the code.

The fourth requirement set forth in the new subsection (c) provides that under the plan to provide for the payment of medical, etc., benefits it must be impossible, at any time prior to the satisfaction of all liabilities under the plan to provide such benefits, for any part of the corpus or income of such separate account to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of such medical, etc., benefits. Thus, the new subsection (c) provides that any portion of the contributions made to fund the medical, etc., benefits under the plan must not be used to finance the pension benefits provided under the plan. Accordingly, if it is possible under the medical, etc., benefit portion of the plan for a payment to be made for any benefit not described in the new subsection (c), the plan will not satisfy the requirements of the new subsection (c) and will not qualify under section 401(a) of the code. However, the payment of any necessary or appropriate expenses in connection with the administration of a plan providing for the payment of medical, etc., benefits is to provide such benefits and does not affect the qualification of the plan.

The fifth requirement set forth in the new subsection (c) provides that, notwithstanding the provisions of section 401(a)(2) of the code, upon the satisfaction of all liabilities under the plan to provide medical, etc., benefits, any amount remaining in such separate account must, under the terms of the trust instrument, be returned to the employer. Thus, any balance remaining with respect to the medical, etc., benefit portion of the plan, after the satisfaction of all liabilities to provide such benefits under the plan, may not be used to finance the pension benefits provided under the plan or to reduce the employer's contributions with respect to such pension benefits. Accordingly, any such remaining amount must revert to the employer and, subject to the tax benefit rule, must be taken into account by him in computing his income.

Section 2 of the bill provides the effective date for the bill. The bill applies to taxable years beginning after the date of the enactment of the bill.

H.R. 10620] [19]

MAXIMUM LIMITATIONS ON MEDICAL, ETC., EXPENSES

[Senate Report No. 2274, Eighty-seventh Congress, Second Session, Calendar No. 2238]

[October 3, 1962]

Mr. Byrd of Virginia, from the Committee on Finance, submitted the following report to accompany H.R. 10620.

The Committee on Finance, to which was referred the bill (H.R. 10620) to amend section 213 of the Internal Revenue Code of 1954 to increase the maximum limitations on the amount allowable as a deduction for medical, dental, etc., expenses, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

[19] Public Law 87–863, page 210, this Bulletin.

I. SUMMARY OF THE BILL

H.R. 10620, as passed by the House, raises the ceiling limitations now applicable to medical expense deductions. Your committee has accepted the House provision without change.

The medical expense deduction ceilings which are generally applicable are doubled by the House bill. Thus, the maximum medical expense deduction which may be taken by married couples, for example, is increased from $10,000 to $20,000, while the maximum which may be taken by single persons is increased from $5,000 to $10,000. In addition, the maximum amount which may be taken with respect to each exemption is increased from $2,500 to $5,000. For those age 65 or over who are disabled, the ceiling also is increased. Where both the taxpayer and his spouse are 65 or over and disabled, the ceiling is increased from $30,000 to $40,000, while the ceiling applicable where only one person is age 65 or over and disabled is increased from $15,000 to $20,000.

II. GENERAL STATEMENT

Under present law, the ceiling on medical expense deductions which may be taken has the effect of denying a deduction for medical expenses in the extreme hardship cases; namely, those cases in which the medical expenses are very large. In some cases, for example the expenses actually exceed the individual's income for the year. Your committee agrees with the House that in these and other such hardship cases the taxpayer should not be required to pay income tax with respect to income which must be devoted to the payment of legitimate medical bills. On the other hand, it is also recognized that it is difficult to accurately determine what constitutes a medical expense, and cases have arisen where items involving large expenses, which may not constitute proper medical expense deductions, nevertheless have been taken and allowed. In order to foreclose the deduction of these questionable types of items, it is necessary to retain some ceiling limitations on medical expense deductions, at least until it is possible to more accurately define proper medical expenses.

In view of these considerations, present law is amended in effect to double the generally applicable medical expense deductions ceilings. Also, ceilings applicable to those age 65 or over who are disabled are increased.

Under present law, a taxpayer is entitled to medical expense deductions of $2,500 per exemption (not including extra exemptions for blindness or age 65 or over). The bill raises this to $5,000. In addition, under present law, the maximum medical expense deduction of married couples filing joint returns, heads of households, and surviving spouses is limited to $10,000 without regard to the number of exemptions. The bill increases this limitation to $20,000. For other single persons, present law provides a maximum medical expense deduction of $5,000. The bill increases this to $10,000.

As special exceptions to the ceilings described above, present law provides that the maximum medical expense deduction for a taxpayer who is 65 or over and is disabled, or a taxpayer who files a joint return with a spouse who has reached age 65 and is disabled, is $15,000. The bill raises this ceiling to $20,000. Present law also provides that the maximum medical expense deduction on a joint return where both the taxpayer and his spouse have reached age 65 and both are disabled is $30,000. The bill increases this to $40,000.

The changes made by this provision apply with respect to taxable years beginning after December 31, 1961.

III. DEPARTMENTAL REPORT

Treasury Department,
September 27, 1962.

Hon. Harry F. Byrd,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

Dear Mr. Chairman: This is in response to a request for the views of this Department on H.R. 10620 as amended and passed by the House of Representatives on September 11, 1962. This bill is entitled "An act to amend section 213 of the Internal Revenue Code of 1954 to increase the maximum limitations on the amount allowable as a deduction for medical, dental, etc., expenses."

H.R. 10620 would liberalize the medical expense deduction by raising the amount of the dollar limitations on the deductibility of medical expenses.

Present law allows taxpayers within certain prescribed limits to take an itemized deduction for medical expenses. The deduction is limited to the portion of the taxpayer's medical expenses that exceeds 3 percent of his adjusted gross income. However, if either the taxpayer or his spouse has reached the age of 65 before the close of the taxable year this 3-percent limit does not apply to their own medical expenses but only to medical expenses incurred for their dependents.

In addition, the medical expense deduction is generally subject to a maximum limitation of $2,500 per exemption (not including exemptions for age and blindness), and to a maximum overall limit of $5,000 for a single taxpayer or a married taxpayer filing a separate return, and $10,000 for a taxpayer filing a joint return or a head of household. Under H.R. 10620, these limitations would be doubled so that the new ceiling would henceforth be $5,000, $10,000 and $20,000, respectively.

The dollar limitations just described apply to all taxpayers except that larger dollar limits are provided for elderly, disabled taxpayers. For these, the maximum limitation under present law is $15,000, where either the taxpayer or his spouse has attained the age of 65 and is disabled, and is $30,000 on a joint return where both the taxpayer and his spouse are over 65 years of age and disabled. The House bill would raise these limitations to $20,000 and $40,000 respectively.

The legislation would be effective for taxable years beginning after December 31, 1961.

The medical expense deduction is intended to provide a limited deduction for extraordinary medical expenses. Since its adoption in 1942, the deduction has been liberalized a number of times in keeping with changing conditions. The ever-increasing costs of medical care is a matter of serious concern to us all, and the Treasury is not unaware that the expenses of certain illnesses are prohibitive and, in some cases, the cause of serious hardships to many taxpayers.

The principal problem in the administration of the medical expense deduction is determining what is a medical expense. In the past there has been some abuse in the claiming of ordinary living expenses as medical expenses. As the maximum dollar limits to the deduction are raised, it becomes increasingly difficult to prevent the claiming of such living expenses as medical expenses.

The Treasury is presently considering as part of its studies on major tax reform the whole subject of medical expense deduction. In this study, an appraisal is to be made not only of the limitation in present law but also of the definition of items includible in the term "medical expense" as well as other related matters. It would seem inopportune at this point to proceed with a partial amendment of a provision that is under comprehensive study since recommendations shortly may be forthcoming for revision of the whole provision, including the portion which the House bill would now change.

For this reason the Department is opposed to the enactment of H.R. 10620 at this time.

The Department has been advised by the Bureau of the Budget that there is no objection from the standpoint of the administration's program to the submission of this report to your committee.

Sincerely yours,

Stanley S. Surrey,
Assistant Secretary.

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[H.R. 10117] [20]

INCLUSION OF MEDICAL, ETC., BENEFITS UNDER QUALIFIED PENSION PLANS

[Senate Report No. 2266, Eighty-seventh Congress, Second Session, Calendar No. 2229]

[October 2 (legislative day, October 1), 1962]

Mr. Byrd of Virginia, from the Committee on Finance, submitted the following report to accompany H.R. 10117.

The Committee on Finance to whom was referred the bill (H.R. 10117) to amend section 401 of the Internal Revenue Code of 1954 to provide that plans

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[20] The provisions of H.R. 10117 were incorporated in H.R. 10620, passed in Public Law 87–863, page 210, this Bulletin.

which provide certain medical and other benefits for retired employees and their families may be qualified pension plans, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

I. SUMMARY OF BILL

Your committee has accepted the House provision without change but has added a new provision to the bill.

H.R. 10117, as passed by the House, would allow a pension plan, qualified under the Internal Revenue Code of 1954, to provide for the payment of benefits for sickness, accident, hospitalization, and medical expenses of retired employees and their spouses and dependents, if such benefits are subordinate to the retirement benefits provided by the plan.

Under the committee amendment, a taxpayer who has not exercised an option within the time prescribed by regulation to treat intangible drilling and development expenditures in connection with oil and gas wells as expenses for Federal income tax purposes would be granted a new option to do so, to be exercised not later than December 31, 1962. The option, if exercised, would apply for the first taxable year ending after the date of enactment of this bill and would be binding for all subsequent years in the same manner and to the same extent as if it had been made under appropriate Treasury regulations.

II. INCLUSION OF MEDICAL, ETC., BENEFITS UNDER QUALIFIED PENSION PLANS

The system of providing for the pension needs of workers through qualified employer pension plans has become an important feature of the American scene. It has also become common to provide medical benefits through employer contributions to an insurance plan for employees. In both situations, under present law, if certain conditions are met, the employer may receive a tax deduction for contributions to a pension plan or to an insurance plan and these contributions are not currently includible in income of the employee in the case of pension plans and are not includible in income at all (subject to the limitation in sec. 105) in the case of medical expense insurance. This tax treatment has had a considerable effect on the growth of both types of plans.

A number of employers have provided, under their sickness and accident policies for employees, a continuation of benefits after the employee retires. Since the employee must earn his entitlement to such benefits during his working years, it is often desirable that the sickness and accident insurance to which an employee will be entitled after retirement be funded during the working years in the same way that the employer might fund the employee's pension rights. From the standpoint of the employer, it may be more efficient to fund the pension and insurance programs together in a single qualified plan in order to reduce administrative expenses. The present language of section 401 of the Internal Revenue Code of 1954, however, has been interpreted as making a pension plan which provides other than pension benefits nonqualified, and thus the employer would lose his deduction for amounts contributed. Various other tax advantages of a qualified pension plan would also be lost. This means that under present law employers must incur the added expense of setting up a separate fund, with trustees, etc., to provide for the medical expenses of their retired employees.

This provision would make it possible, where an employer chooses to do so, to provide the medical, etc., benefits through a qualified pension plan rather than being required to do so separately, as under existing law.

This provision provides that where such benefits are included in a pension plan the employer must allocate his total contributions to two separate accounts, one being used to fund pension benefits and the other being used to fund medical benefits. The employer contributions to the medical benefit account must be reasonable and ascertainable. No part of the fund maintained to pay medical benefits may be used at any time to pay pension benefits. These requirements are necessary in order to preserve the limitations in section 404 dealing with the amount of the employer pension contribution that may be deductible.

The medical benefits that might be covered for retired employees include the same type of benefits that can be provided now in a plan under section 105. This includes benefits for sickness, accident, hospitalization, and medical expenses of the character described in section 213 of the Internal Revenue Code as they relate

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to the retired employee, his spouse, or dependents. The bill would be effective for taxable years beginning after the date of its enactment.

It is estimated that the revenue loss under this provision would be negligible since the purpose of the provision is essentially to simplify administration of such benefits.

III. NEW ELECTION FOR EXPENSING INTANGIBLE DRILLING AND DEVELOPMENT COST

Under regulations issued by the Treasury Department an operator or other taxpayer who holds working or operating rights in oil or gas properties, and who pays or incurs intangible drilling and development costs in connection with those properties may, at his option, treat such costs as expenses, which for Federal income tax purposes are deductible currently. This option must be exercised on the tax return for the first taxable year in which the taxpayer pays or incurs intangible drilling and development expenditures. Once exercised the option is binding upon the taxpayer for the first taxable year for which it is made and for all subsequent taxable years. If the option is not properly exercised—that is, if it is not made on the tax return for the first taxable year for which intangible drilling and development expenditures are paid or incurred—it may not, under the regulations, be made in a later year, and the taxpayer must capitalize such expenditures and amortize them over the life of the oil or gas well.

Expenditures to which this option applies include all expenditures made by an operator for wages, fuel, repairs, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas. Examples of these expenditures include costs paid or incurred for the drilling, shooting, and cleaning of wells; in such clearing of ground, roadmaking, surveying, and geological work as are necessary in preparation for the drilling of wells; and in the construction of derricks, tanks, pipelines, and other physical structures necessary for the drilling of wells and the preparation of wells for the production of oil or gas.

The attention of your committee has been called to situations where, through oversight, the option to deduct intangible drilling and development costs was not exercised within the time specified in the regulations with the result that some taxpayers have been placed at a considerable disadvantage as compared to competing oil and gas producers. Because the Treasury regulations issued pursuant to section 263(c) of the Internal Revenue Code of 1954 do not permit a taxpayer who failed to exercise a binding option for the first taxable year for which he paid or incurred intangible drilling and development expenditures to do so with respect to any subsequent taxable year, and in view of the competitive situation which follows a failure to exercise a binding option, your committee believes it appropriate to provide a second chance to elect to expense such costs.

For this reason, in the case of a taxpayer who may not exercise an option under the appropriate Treasury regulations (Regs. sec. 1.612–4, Internal Revenue Code of 1954), your committee's admendment grants a new option to treat intangible drilling and development expenditures with respect to oil and gas wells as expenses which are deductible currently for Federal income tax purposes. Under the amendment this option must be exercised on or before December 31, 1962. An option under the committee amendment will apply with respect to the first taxable year of the taxpayer ending on or after the date of the enactment of this bill. If an option is exercised under this provision it is to be binding on the taxpayer in the same manner and to the same extent as if it had been made under the appropriate regulations of the Treasury Department.

IV. DEPARTMENTAL REPORT

TREASURY DEPARTMENT,
Washington, September 24, 1962.

HON. HARRY F. BYRD,
Chairman, Senate Finance Committee,
New Senate Office Building, Washington, D.C.

MY DEAR MR. CHAIRMAN: This is in reference to H.R. 10117, a bill to amend section 401 of the Internal Revenue Code of 1954 to provide that plans which provide certain medical and other benefits for retired employees and their familes may be qualified pension plans.

This bill would allow a pension plan qualified under the Internal Revenue Code to provide for the payment of benefits for sickness, accident, hospitalization, and medical expenses of retired employees and their spouses and dependents provided that such benefits are subordinate to the retirement benefits provided by the plan and that certain specified requirements are met which are designed to keep separate the funds contributed for the two types of benefits. At present, a qualified pension cannot provide for the payment of the benefits covered by the bill. The income tax regulations specifically state that a plan is not a pension plan if it provides for the payment of benefits not customarily included in a pension plan, such as layoff benefits or benefits for sickness, accident, hospitalization, or medical expenses.

It is important to note that, although an employer may not now provide medical benefits to his retired employees and their families through the medium of a qualified pension trust, he can make such benefits available through the use of a separate plan with no less tax advantage to himself or to his retired employees. For example, while contributions which an employer makes toward the purchase of medical and other related benefits for his employees are not deductible under section 404 of the Internal Revenue Code relating to deductions for contributions to pension plans, they are fully deductible under section 162 of the code as ordinary and necessary business expenses. Similarly, under section 106 of the code, employer contributions for medical benefits are not includible in the gross income of their employees. In addition, under section 501(c)(9) of the code, voluntary employees' beneficiary associations which pay life, sick, accident, or other benefits to members of their dependents are exempt from taxation, providing that no part of the net earnings other than normal payments inures to the benefit of any private shareholder or individual and 85 percent or more of the association's income comes from employer or employee contributions.

It is apparent, therefore, that present law already grants separate plans providing employer-financed medical benefits favorable tax treatment comparable to that which would be accorded if such plans could be incorporated in qualified pension plans under the proposed legislation. However, allowing pension and medical care benefits for employees to be provided under a single trust instead of under two separate trusts might make possible a slight decrease in the costs of establishing and administering plans providing such benefits.

Although no substantial benefit to employers or employees is apparent in the proposed legislation, the Treasury Department has no objection to the enactment of H.R. 10117.

The Bureau of the Budget has advised the Treasury Department that there is no objection from the standpoint of the administration's program to the presentation of this report.

Sincerely yours,

STANLEY S. SURREY,
Assistant Secretary.

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[H.R. 10620] [21]

MAXIMUM LIMITATIONS ON MEDICAL, ETC., EXPENSES

[Conference Report No. 2555, Eighty-seventh Congress, Second Session]

[October 11, 1962]

MR. MILLS, from the Committee of conference, submitted the following Conference Report to accompany H.R. 10620.

The Committee of conference on the disagreeing votes of the two Houses on the amendments of the Senate to the bill (H.R. 10620) to amend section 213 of the Internal Revenue Code of 1954 to increase the maximum limitations on the amount allowable as a deduction for medical, dental, etc., expenses having met.

[21] Public Law 87–863, page 210, this Bulletin.

after full and free conference, have agreed to recommend and do recommend to their respective Houses as follows:

That the Senate recede from its amendments numbered 6, 7, and 8.

That the House recede from its disagreement to the amendments of the Senate numbered 1, 2, 3, 4, and 5, and agree to the same.

W. D. MILLS,
CECIL R. KING,
HALE BOGGS,
NOAH MASON,
JOHN W. BYRNES,
Managers on the Part of the House.
HARRY F. BYRD,
ROBT. S. KERR,
RUSSELL LONG,
JOHN J. WILLIAMS,
Managers on the Part of the Senate.

STATEMENT OF THE MANAGERS ON THE PART OF THE HOUSE

The managers on the part of the House at the conference on the disagreeing votes of the two Houses on the amendments of the Senate to the bill (H.R. 10620) to amend section 213 of the Internal Revenue Code of 1954 to increase the maximum limitations on the amount allowable as a deduction for medical, dental, etc., expenses submit the following statement in explanation of the effect of the action agreed upon by the conferees and recommended in the accompanying conference report.

Amendment No. 1: Senate amendment No. 1 adds a new section 2 to the House bill. The proposed section 2 contains the substance of H.R. 10117, as passed by the House. The amendment would allow a pension or annuity plan, qualified under the Internal Revenue Code of 1954, to provide for the payment of benefits for sickness, accident, hospitalization, and medical expenses of retired employees and their spouses and dependents, if such benefits are subordinate to the retirement benefits provided by the plan. It would make it possible for an employer, where he chooses to do so, to provide these benefits through a qualified pension or annuity plan, rather than being required to do so separately, as under existing law. Under the proposed section 2, this feature would apply to plans funded through insurance, as well as to trusteed plans.

The House recedes.

Amendment No. 2: Under regulations recognized and approved by the Congress in House Concurrent Resolution 50, 79th Congress, and under section 39.23(m)–16 of regulations 118, a taxpayer had an option to charge certain intangible drilling and development costs in connection with oil and gas properties to capital, or to expense such costs. After the taxpayer has exercised this option, he is bound thereby with respect to all optional expenditures covered by the regulation, whenever made, in connection with oil and gas properties.

Senate amendment No. 2 would give a taxpayer who has exercised such an option to capitalize intangible drilling and development costs (rather than deducting such costs as expenses) a new option to deduct such costs as expenses. The new option is granted for the first taxable year ending on or after the date of enactment of the bill, and shall be exercised at the time of filing the return for that year, but otherwise is treated for all purposes as an option exercised under, and subject to, section 263(c) of the Internal Revenue Code of 1954 (relating to intangible drilling and development costs in the case of oil and gas wells) and the regulations prescribed thereunder.

The House recedes.

Amendment No. 3: Under existing law (sec. 5121 of the 1954 code) each State and local government retail liquor store as well as each privately owned retail liquor store is required to pay an annual special occupational tax of $54. Senate amendment No. 3 amends section 5123(b) of such code (which relates to dealers conducting their liquor business in more than one location) so as to provide that a State or political subdivision operating retail liquor stores will be required to pay only one such tax each year instead of paying the tax separately for each store location, and makes additional changes of a purely technical and conforming nature.

The House recedes.

Amendment No. 4: Existing section 1341(a) of the 1954 code provides alternative methods of computing the tax where the taxpayer restores a substantial amount held under claim of right. Senate amendment No. 4 adds two new paragraphs to section 1341(b) to specify rules relating to (1) the treatment of net operating loss carryovers and carrybacks, and capital loss carryovers, for purposes of determining which of the alternative methods of computation will be used, and (2) the treatment of net operating loss carryovers and capital loss carryovers for taxable years after the year of restoration after the determination has been made as to which of the alternative methods of computation will be used.

The House recedes.

Amendment No. 5: Existing section 7608 of the 1954 code provides that internal revenue officers who are charged with the duty of enforcing subtitle E of the code or other Federal laws pertaining to liquor, tobacco, and firearms shall have certain specified powers (including the power to carry firearms, to serve warrants, subpenas, and summonses, and to make certain arrests and seizures in the performance of their duty). Senate amendment No. 5 adds to section 7608 a new subsection (b) which would provide that criminal investigators of the Intelligence Division or Internal Security Division of the Internal Revenue Service who are charged with the duty of enforcing any of the criminal provisions of the internal revenue laws (or other criminal provisions relating to internal revenue) shall have power to execute and serve search and arrest warrants and serve Federal subpenas and summonses, to make arrests without warrants for offenses involving the internal revenue laws, and to seize property subject to forfeiture under such laws.

The House recedes.

Amendment No. 6: Section 4521 of the Internal Revenue Code of 1954 provides for the imposition of an import tax on certain petroleum products. Senate amendment No. 6 added a new section 4522 to the code to provide that no tax is to be imposed under section 4521 on any article sold for use as fuel on vessels of the United States employed as common carriers on the high seas or the Great Lakes pursuant to certification by the Interstate Commerce Commission.

The Senate recedes.

Amendment No. 7: Section 824(a) of the Internal Revenue Code of 1954 (as contained in sec. 8 of the Revenue Act of 1962) provides that in determining the statutory underwriting income or loss of certain mutual casualty insurance companies for the taxable year there is to be allowed a special deduction in the case of any company having a "concentrated windstorm, etc., premium percentage" of more than 40 percent. In determining this percentage, the computation may be made on the basis of an area consisting of one State, or an area within 200 miles of any fixed point selected by the taxpayer.

Senate amendment No. 7 added a third alternative area as a basis for the computation; namely, an area within 400 miles of any fixed point selected by the taxpayer. However, if the taxpayer elected this third alternative, his special deduction was reduced by one-half.

The Senate recedes.

Amendment No. 8: This amendment amended section 543(c)(11) of the Internal Revenue Code of 1954, which deals with an exception from the definition of "personal holding company" for certain small business investment companies. It also amended section 1243 of the code, which deals with the loss of a small business investment company on certain securities acquired pursuant to section 304 of the Small Business Investment Act of 1958.

The Senate recedes.

W. D. Mills,
Cecil R. King,
Hale Boggs,
Noah Mason,
John W. Byrnes,
Managers on the Part of the House.

[H.R. 12599] [22]

INCOME TAX TREATMENT OF TERMINAL RAILROADS

[Senate Report No. 2273, Eighty-seventh Congress, Second Session, Calendar No. 2237]

[October 3, 1962]

Mr. Byrd of Virginia, from the Committee on Finance, submitted the following report to accompany H.R. 12599.

The Committee on Finance, to whom was referred the bill (H.R. 12599) relating to the income tax treatment of terminal railroad corporations and their shareholders, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

I. SUMMARY OF BILL

Your committee has added three provisions to the House bill, H.R. 12599, as well as making relatively minor modifications in the House-passed provisions.

The bill as passed by the House deals with the income tax treatment of a terminal railroad corporation and its railroad shareholders. Under certain court decisions a corporation is taxed on its profits even if it uses these profits to supply services to a shareholder at less than cost. Also, the shareholder is treated as if it had paid at least cost for any services rendered to it and received the profits attributable to the undercharge in the form of a dividend. The bill creates a special exception to these two rules in the case of terminal railroad corporations and their railroad shareholders. Where such a terminal railroad corporation offsets a charge for services performed for a railroad shareholder, by crediting railroad terminal income against this charge, the terminal railroad corporation is not to be treated as having received the portion of the charge so offset, nor is this portion to be rendered taxable to the terminal railroad corporation through the disallowance of deductions. The railroad shareholder is not to be taxed on the portion of the charge satisfied with the related terminal income nor is it to receive a deduction as having paid such portion.

The three new provisions added by your committee to this bill are as follows:

(1) The text of H.R. 12030 (which was reported out unanimously by the Committee on Ways and Means) has been added to the bill. This authorizes the Treasury Department to make special statistical studies, etc., to engage in these studies, etc., jointly with parties requesting them, and to furnish the results of the studies to the parties requesting them upon payment of the cost involved. This provision also authorizes the Treasury Department to admit employees of States, local governments, the Commonwealth of Puerto Rico, U.S. possessions, District of Columbia, and any foreign government to training courses conducted by the Internal Revenue Service and to supply them with texts and other training aids. In this case the Treasury is authorized to require the payment of a reasonable fee not to exceed the cost of the training and training aids. The provision further provides that the payments received from these statistical studies and training courses, etc., as well as other work performed for a State or Federal Government agency are to be used to reimburse the appropriations which bore the cost of this work or services.

(2) A provision has been added amending present law to expressly allow a credit or refund of any tax payment where the Tax Court determines that a claim for refund was filed before the date of the mailing of the notice of deficiency involved and could not have been filed at the time of the mailing of the notice of deficiency. (When a petition is filed in the Tax Court as to any particular taxable year the Tax Court acquires jurisdiction of all issues as to that year, including pending refund claims and pending suits for refund.)

(3) A provision has been added defining cooperative banks in the same manner as domestic savings and loan associations and subjecting them to the same investment requirements, for purposes of determining whether they are to be eligible for the special bad-debt reserve deductions applicable to such organizations. In general this bad-debt reserve deduction under the revenue bill of 1962 is to be equal to the greater of 60 percent of taxable income, or an amount necessary to bring reserves up to 3 percent of loans.

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[22] Public Law 87–870, page 213, this Bulletin.

II. INCOME TAX TREATMENT OF TERMINAL RAILROADS AND THEIR SHAREHOLDERS

A. GENERAL EXPLANATION

Under court decisions, if a corporation supplies services to a shareholder at less than cost (making up this loss from profits on business done with other persons), the shareholder is treated as having received a dividend. Moreover, since dividends and other distributions to shareholders are not deductible by the corporation, the profit on the business done with the other persons represents taxable income to it. The courts have reached this latter result under two different theories. In *Anaheim Union Water Co.* (35 T.C. 1072 (1961); now on appeal in the ninth circuit), it was held that the corporation is not entitled to any deductions for expenses attributable to the services rendered the shareholder in excess of the amount charged the shareholder. In *Chicago and Western Indiana Railroad Co.* v. *Commissioner* (seventh circuit, May 1, 1962, affirming Tax Court memo opinion), the terminal corporation was treated as having constructively received from its shareholder the agreed charge for the services rendered, and then as having credited its shareholder with the profit attributable to the business done with other persons.

Because of these decisions, where a number of railroads own a corporation operating a terminal, the terminal corporation remains taxable on the profits earned by it on newsstands, restaurants, and similar terminal facilities, even though it uses all of these profits to decrease the charges made to the railroad shareholders for services supplied to them. Thus, as a result of the *Chicago and Western Indiana Railroad Co.* decision, a large amount of tax is now due from terminal railroad corporations for a number of past years.

However, the amount by which the income of the railroad terminal corporation is increased under the decision may also represent the amount by which the railroad shareholders understated their deductions. This can be illustrated by assuming that a railroad terminal corporation had $100 of terminal income from newsstands, restaurants, etc. Under the decision, the terminal corporation would have taxable income of $100 from this source and, at the 52-percent corporate rate, would be liable for tax of $52. Assume further that the railroad shareholders of the terminal corporation were all operated at a profit, that they received services from the terminal corporation costing such corporation $100, and that instead of paying cost for these services the railroad shareholders were credited with the $100 of terminal income. If this $100 credit is treated as being in effect a $100 dividend to the railroad shareholders, and if the railroad shareholders are treated as having paid the full cost of the services (unadjusted by any crediting), there will be a decrease in the tax liability of the railroad shareholders. The $100 dividend received by the railroad shareholders would be eligible for the 85-percent intercorporate dividend received deduction, leaving only $15 of the $100 subject to tax. At a 52-percent rate this would mean a tax of $7.80. At the same time the business deductions of the railroad shareholders would be increased by $100 (the amount of the increase deemed to have been paid for services rendered). Thus, in this case the effect of the court decision is to increase the terminal corporation's tax by $52 and to decrease the railroad shareholder's tax by $44.20 ($52 minus $7.80), an overall net tax increase, for the terminal railroad corporation and its shareholders, of only $7.80.

The hardship arises, however, where the railroad shareholders have net operating losses for a period of years. In such cases there is no comparable decrease in their tax liability. Thus, in the above example if the railroad shareholders have not been paying taxes because of losses, there is the $52 increase in the terminal corporation's tax liability but no comparable $44.20 decrease in the railroad shareholders' income tax. Thus, in cases involving loss railroad corporations the overall net increase in tax in this example is $52 rather than the $7.80 which occurs in the case of railroad corporations with taxable incomes.

Your committee agrees with the House that with the financial problems faced by the railroads at the present time it is undesirable to increase their overall tax burdens. Moreover, it is believed that to do so would not be in harmony with the intent of the President's transportation message. Information available indicates that most of the major railroads are owners of joint facility stock and users of joint facility services. The problem is particularly acute due to the fact that under State law joint facilities to be used by railroads must be operated by a corporation.

Your committee also agrees with the House that it would be particularly unfortunate to make an especially large increase in the tax burden of terminal railroad corporations owned by loss railroads, since the shareholders must bear this additional tax burden.

For the above reasons it has been concluded that special rules should be provided for these terminal railroad corporations so that they will not be taxed on related terminal income which is used to reduce the service charges to the railroads. On the other hand, the railroads involved will not be entitled to expense deductions in excess of the actual costs borne by them.

To accomplish this result the new section is to apply to all years to which the Internal Revenue Code of 1954 or the Internal Revenue Code of 1939 apply. In order to avoid the disappointment of any taxpayer's reasonable expections, the availability of the operative provisions of this bill for past years has been made to depend on the manner in which the income of a terminal railroad corporation was originally reported by the terminal railroad corporation and its shareholders. Your committee has modified the bill as passed by the House to reopen only those years closed on the date of enactment in which a terminal railroad corporation or its shareholders originally reported income in the manner provided by the bill for such a corporation or its shareholders. Additionally, your committee's amendments provide that adjustments of taxable income available with respect to any closed year which is reopened by this bill are confined to adjustments resulting from the treatment by a terminal railroad corporation or its shareholders of the income of a terminal railroad corporation in the manner provided in the new provision. In each instance in which an adjustment of taxable income for a closed year is available, it becomes so only upon the consent of all of the affected parties to appropriate adjustments for that year.

B. TECHNICAL EXPLANATION

Subsection (a) of the first section of the bill, as amended, adds a new part X to subchapter B of chapter 1 of the Internal Revenue Code of 1954. The new part, which relates to the treatment of terminal railroad corporations and their shareholders, consists of new section 81 which is explained below.

SECTION 281. TERMINAL RAILROAD CORPORATIONS AND THEIR SHAREHOLDERS

(*a*) *Computation of taxable income of terminal railroad corporations*

Subsection (a) of section 281 provides special rules for computing the taxable income of a terminal railroad corporation (as defined in sec. 281(d)(1)).

Paragraph (1)(A)(i) of the new section 281(a) provides that a terminal railroad corporation is not to be considered to have received or accrued the portion of any liability of any railroad corporation which is discharged by crediting that liability, if the following conditions are met. The terminal railroad corporation must have discharged, on its books and in fact, that portion of the liability of the railroad corporation payable to the terminal railroad corporation by crediting that liability with an amount of related terminal income (as defined in sec. 281(d)(2)). The liability which is discharged must be a liability with respect to related terminal services (as defined in sec. 281(d)(3)) provided by the terminal railroad corporation to the railroad corporation. Moreover, that portion of the liability must be discharged pursuant to an agreement as provided in section 281(c).

Paragraph (1)(A)(ii) of the new section 281(a) provides that a terminal railroad corporation is not to be considered to have received or accrued the portion of any charge which would be made by the terminal railroad corporation to the railroad corporation but which is not made, if the following conditions are met. The portion of the charge which is not made must result from the terminal railroad corporation having taken related terminal income (as defined in sec. 281(d)(2)) into consideration in computing the net charge to the railroad corporation. The portion of the charge which is not made must be a charge which would otherwise have been made with respect to related terminal services (as defined in sec. 281(d)(3)) provided by the terminal railroad corporation to the railroad corporation. Moreover, the reduction of the charge must have been made pursuant to an agreement as provided in section 281(c).

Paragraph (1)(B) of the new section 281(a) is to apply under the same conditions as under paragraph (1)(A). Paragraph (1)(B) provides that no deduction, which would otherwise be allowable to the terminal railroad corporation

under chapter 1 of the 1954 Code, is to be disallowed merely because a liability is discharged as described in paragraph (1)(A)(i). Similarly, no deduction, which would otherwise be allowable to the terminal railroad corporation under such chapter 1, is to be disallowed merely because of the computation of charges as described in paragraph (1)(A)(ii).

Paragraph (2) of the new section 281(a) provides a limitation on the application of paragraph (1). Paragraph (1) is not to apply to the extent that it would (but for this limitation under par. (2)) operate to create (or increase) a net operating loss of the terminal railroad corporation for the taxable year. This limitation is to apply only to taxable years of terminal railroad corporations ending after the date of enactment of the new section 281.

The application of subsection (a) may be illustrated by the following examples:

Example 1.—The X terminal railroad corporation charges its shareholder railroad corporations for the use of its services and facilities on a wheelage or user basis. At the end of each year, the shareholder railroad corporations' liabilities are reduced (in proportion to their respective stock ownership), pursuant to an agreement (as provided in sec. 281(c), by the net income from all sources (computed without regard to Federal income taxes). For the calendar year 1963, the X corporation charges its shareholders $105 with respect to related terminal services. This liability is discharged in part by crediting it with $36 (the net income from all sources), resulting in a net shareholder liability of $69. The X corporation's income from all sources is determined to be as follows:

Source	Receipts or accruals	Costs of operations	Income (or loss)
(1) Related terminal income from dealings with nonshareholders	$30	$20	$9
(2) Nonrelated terminal income	24	12	12
(3) Related terminal income from dealings with shareholder railroad corporations	105	90	15
Total	159	123	36

Under Section 281(a)(1)(A)(i), the X corporation is not to be considered to have received or accrued income of $24 (related terminal income of $9 from nonshareholders and $15 from shareholders), by reason of the discharge of $36 of shareholder railroad corporations' liabilities. Similarly, under section 281(a)(1)(B), to the extent of $24 the X corporation is not to be disallowed deductions by reason of the discharge of shareholder railroad corporations' liabilities.

Example 2.—The Y terminal railroad corporation charges its shareholder railroad corporations for the difference between the cost of operations for the use of its services and facilities provided to the shareholders and its net income from all other sources. This net charge is computed at the end of each year pursuant to an agreement (as provided in sec. 281(c)), which provides that Federal income taxes shall not be taken into account for purposes of the computation. For the calendar year 1964, the Y corporation charges its shareholders $69 with respect to related terminal services. The Y corporation's income from all sources is determined to be as follows:

Source	Receipts or accruals	Costs of operations	Income (or loss)
(1) Related terminal income from dealings with nonshareholders	$30	$21	$9
(2) Nonrelated terminal income	24	12	12
Total	54	33	21
(3) Dealings with shareholders	--------	90	(90)
Due from shareholders	--------	--------	69

Under section 281(a)(1)(A)(ii), the Y corporation is not to be considered to have received or accrued income of $9 (related terminal income) by reason of the $21 charge which is not made. Similarly, under section 281(a)(1)(B), to the extent of $9 the Y corporation is not to be disallowed deductions by reason of the fact that the full cost was not charged.

Example 3.—Assume that all of the facts are the same as in example 2, except that the costs of nonrelated terminal activities are $30, instead of $12. In that case, the nonrelated terminal income will be a minus $6. By reason of the limitation of section 281(a)(2), section 281(a)(1)(A)(ii) and (B) will operate with respect to $3 (instead of $9).

(*b*) *Computation of taxable income of shareholders*

Subsection (b) of new section 281 provides special rules for computing the taxable income of a shareholder of a terminal railroad corporation (as defined in sec. 281(d)(1)). This subsection is to apply under the same conditions as under subsection (a)(1)(A). Subject to the limitation provided in subsection (a)(2), no amount is to be considered to have been received or accrued or paid or incurred by a shareholder of a terminal railroad corporation as a result of any discharge of liability described in subsection (a)(1)(A)(i), nor as a result of any computation of charges in the manned described in subsection (a)(1)(A)(ii).

Thus, to the extent that the conditions of subsection (a)(1)(A)(i) or (ii) are satisfied in discharging a liability or computing a charge, a shareholder of the terminal railroad corporation is not to be considered to have paid or incurred an expense. Moreover, to that extent, the shareholder is not to be considered to have received or accrued a dividend. For example, if in examples 1, 2, and 3, illustrating subsection (a), the X and Y railroad terminal corporations each had three shareholders, and if an equal discharge of liability (or computation of charges) resulted for each shareholder, then each of them will not be considered to have received or accrued a dividend nor paid or incurred an expense of $8 in example 1, and $3 in example 2, and $1 in example 3.

(*c*) *Agreement required*

Subsection (c) of new section 281 provides that subsections (a) and (b) are to apply only if the discharge of liability described in subsection (a)(1)(A)(i) or the computation of charges described in subsection (a)(1)(A)(ii) was provided for in a written agreement. The written agreement must have been entered into before the beginning of the taxable year to which subsections (a) and (b) are to apply. All shareholders of the terminal railroad corporation must have been parties to the written agreement. Thus, if a written agreement, to which all of the shareholders are parties, and which was entered into before the taxable year, provides that the net revenues are to be credited as reductions of rental obligations of the shareholders, subsections (a) and (b) would apply to such an arrangement. However, if, for example, the agreement provides that the net revenues are to be divided among the shareholders and that such revenues are not to be applied to reduce liabilities incurred by such shareholders with respect to terminal services but are to be distributed to them in cash or are to be held subject to their unconditional right of withdrawal in cash, then subsections (a) and (b) would not apply to this arrangement.

(*d*) *Definitions*

Subsection (d) of the new section 281 defines the terms "terminal railroad corporation," "related terminal income," and "related terminal services."

(1) *Definition of terminal railroad corporation.*—Paragraph (1) of the new subsection (d) contains a definition of a terminal railroad corporation. Such term means a domestic railroad corporation which is not a member, other than as a common parent corporation, of an affiliated group (as defined in sec. 1504 of the code, and as determined without regard to whether or not the affiliated group makes a consolidated return for the taxable year), and which also meets four other requirements.

The first of these requirements provides that all of the shareholders of the terminal railroad corporation must be domestic railroad corporations subject to part I of the Interstate Commerce Act. If any one of the shareholders of a terminal railroad corporation is not so qualified, because, for example, it is a foreign corporation or a corporation not subject to part I of the Interstate Com-

merce Act, then that terminal railroad corporation would not be within the scope of new section 281.

The second requirement provides that the primary business of the terminal railroad corporation is providing railroad terminal and switching facilities and services to domestic railroad corporations subject to part I of the Interstate Commerce Act and to the shippers and passengers of such railroad corporations. Thus, a terminal railroad corporation would meet this requirement if its primary business consists of the operation of (1) a switching service only, (2) terminal trackage or facilities only, such as a union passenger or freight station, or stock-yards, etc., (3) railroad bridges or ferries only, or (4) any combination of the foregoing. For purposes of this requirement, terminal facilities may be provided by leasing such facilities to another railroad corporation.

The third requirement provides that a substantial part of the services rendered by the terminal railroad corporation for the taxable year must be rendered to one or more of the shareholders of the terminal railroad corporation.

The fourth requirement provides that each shareholder of a terminal railroad corporation must compute its taxable income on the basis of a taxable year which begins or ends on the same day as the taxable year of the terminal railroad corporation. This requirement is a slight modification of that contained in the bill as passed by the House. It insures that a short taxable year of a shareholder of a terminal railroad corporation, which might, for example, result from a merger, will not deprive an otherwise qualified terminal railroad corporation of the benefits of the bill.

(2) *Definition of related terminal income.*—Paragraph (2) of the new section 281(d) contains a definition of related terminal income of a terminal railroad corporation. Such term means the income (determined in accordance with regulations prescribed by the Secretary of the Treasury or his delegate) of a terminal railroad corporation derived from any one or more of four sources.

Subparagraph (A) of subsection (d)(2) states that one source of related terminal income includes income derived from services or facilities of a character ordinarily and regularly provided by terminal railroad corporations for railroad corporations or for the employees, passengers, or shippers of railroad corporations. This class of income would include income from switching operations for railroads, and from renting or operating restaurants, barbershops, newsstands, or other similar passenger facilities, in waiting rooms or along passenger concourses. Income from the operation of a small hotel primarily for the employees of the railroads would also be included under this subparagraph. However, the income from the operation of a hotel for passengers or other persons would not qualify as related terminal income. The income produced from making available facilities for railroad shippers (including express companies and freight forwarders), such as sheds or warehouses, although not directly intended for railroad use, would qualify as related terminal income.

Subparagraph (B) of subsection (d)(2) provides that another source of related terminal income includes income derived from the use by persons other than railroad corporations of a portion of a facility, or of a service, which is used primarily for railroad purposes. Thus, for example, if a terminal railroad corporation owns a bridge across a river which has on it both railroad tracks and an automobile roadway, and if the primary purpose for the continued operation of the bridge is to serve railroad corporations, the income derived from the tolls charged automobiles to use the automobile roadway would qualify as related terminal income. Also, if a terminal railroad corporation had a steam plant primarily operated to supply steam for the terminal, but if excess steam is sold to another business in the neighborhood, the income produced by the sale of this steam would qualify as related terminal income. Moreover, income produced either by operating a commuter service or by renting tracks and facilities for a commuter service to an independent operator would qualify as related terminal income. Similarly, the sale or rental of advertising space on either the inside or outside of the terminal for signs and other advertising displays would qualify as related terminal income. However, the income produced by the operation for general public use of a large hotel or office building (whether or not this was physically part of the same structure as the terminal) would not be related terminal income. Likewise, if oil or natural gas or any other mineral is discovered on property owned or leased by the terminal railroad corporation, the income produced from this discovery would not be related terminal income.

Subsection (d)(2) also provides that any substantial addition constructed after the date of enactment of this bill shall be treated as a separate facility for purposes of subsection (d)(2)(B). Thus, for example, if after the date of enactment, a terminal railroad corporation constructs a five-story addition above its present terminal building, which addition is devoted to offices rented to the general public, the income from this addition will not be considered related terminal income, since such addition is not used primarily for railroad purposes. However, the income from the small number of offices which were included in the terminal building before the addition will continue to be considered related terminal income. Furthermore, if a substantial addition constructed after the enactment of this bill is used primarily for railroad purposes, the income from such facility will qualify as related terminal income.

Subparagraph (C) of subsection (d)(2) provides that another source of related terminal income includes income received from any railroad corporation for services or facilities provided by such terminal railroad corporation in connection with railroad operations. This subparagraph would include, for example, income produced by the use of switching facilities, or the lease of such facilities, or the lease or operation of a beltline or bypass railroad. Also included would be income produced by the renting of office space in a terminal office building to any railroad corporation for such corporation's administrative or operating divisions.

Subparagraph (D) of subsection (d)(2) provides that related terminal income includes payment received for facilities or services in connection with mail handling.

Gain realized from the sale of terminals, terminal equipment, and other assets owned by the terminal railroad corporation will not qualify as related terminal income.

(3) *Definition of related terminal services.*—Paragraph (3) of the new subsection (d) contains a definition of related terminal services. Such term means only the services or use of facilities taken into account in computing related terminal income. Included in this term, for example, are switching or terminal services, furnishing terminal trackage or facilities or operating bridges or ferries for railroad purposes.

(e) Application to taxable years ending before the date of enactment

Subsection (e) of the new section 281 provides two rules for applying section 281 to taxable years ending before the date of enactment of section 281. Paragraph (1) of this subsection applies to all cases whether or not the taxable year involved of one or more of the parties is closed. Paragraph (2) only applies when the taxable year of one or more of the parties is closed.

Paragraph (1) of the new section 281(e) provides, for taxable years ending before the date of enactment of this section, that section 281 is to apply to a terminal railroad corporation (as defined in sec. 281(d)(1)) only to the extent that it had computed its taxable income on its return in the manner described in section 281(a). Similarly, section 281 is to apply to a shareholder of a terminal railroad corporation only to the extent that it had computed its taxable income on its return in the manner described in section 281(b). The return on which the taxable income is required to have been computed in the described manner must have been filed on or before the due date (including the period of any extension of time) for filing the return for the applicable taxable year.

The application of paragraph (1) may be illustrated by the following example:

Assume that all of the facts are the same as in example 1 illustrating subsection (a), except that the calendar year 1954 is the year involved. Assume further, that of the related terminal income from dealings with nonshareholders of $9, $3 is attributable to income derived from the United States in payment for services in connection with mail handling, and that this $3 was reflected in taxable income on the return of the X terminal railroad corporation. Under section 281(a), the X terminal railroad corporation is not to be considered to have received or accrued income, nor is it to be disallowed deductions, by reason of the discharge of shareholder railroad corporations' liabilities, of $21 (instead of $24).

Assume, additionally, that the X terminal railroad corporation had three shareholders and an equal discharge of liability resulted for each of them. Since each shareholder treated this $1 discharge of liability (attributable to income derived from the United States in connection with mail handling) as a dividend.

on its return, each shareholder will not be considered to have received or accrued a dividend nor paid or incurred an expense of $7 (instead of $8).

Paragraph (2) of the new section 281(e) contains four special provisions for applying section 281 to a taxable year for which either assessment of any deficiency, or refund or credit of any overpayment, whichever is applicable, is barred by operation of any law or rule of law. This paragraph will not apply to a taxable year for which either assessment or refund is barred by a closing agreement, a compromise, or a decision of the Tax Court entered pursuant to a stipulated settlement. This paragraph will apply to a taxable year of a terminal railroad corporation only if refund or credit of any overpayment for such taxable year was barred on the date of the enactment of this section.

Subparagraph (A) of subsection (e)(2) provides that this paragraph is to apply only to the extent that overpayment of income tax would result if the terminal railroad corporation were permitted to recompute its taxable income in the manner described in subsection (a).

Subparagraph (B) of subsection (e)(2) provides that this paragraph is to apply only if claim for credit or refund of overpayment which would result from the recomputation described in subparagraph (A) is filed prior to 1 year after the date of enactment of this section.

Subparagraph (C) of subsection (e)(2) provides that this paragraph is to apply only to the extent that the terminal railroad corporation computed its taxable income in the manner described in subsection (a) on its timely filed return for such taxable year.

Subparagraph (D) of subsection (e)(2) provides that this paragraph is to apply only if each railroad corporation, which was a shareholder of the terminal railroad corporation during such taxable year, consents in writing to the assessment of any deficiency for any year to the extent attributable to the recomputation of its taxable income in the manner described in subsection (b) correlative to its allocable share of the adjustment of taxable income made by the terminal railroad corporation in its recomputation under subparagraph (A). This assessment period may be extended to any time to which the taxpayer and the Secretary of the Treasury or his delegate may agree. The consent will extend the assessment period even though the assessment of the deficiency would otherwise be prevented by the operation of any law or rule of law at the time of filing the consent.

(f) Regulations

Subsection (f) of the new section 281 requires the Secretary of the Treasury or his delegate to prescribe such regulations as may be necessary to carry out the purposes of the new section 281.

Subsection (b) of the first section of the bill provides a clerical amendment to the table of parts of subchapter B of chapter 1 of the Internal Revenue Code of 1954.

Section 2(a) of the bill provides that the amendments made by the bill to the Internal Revenue Code of 1954 are to apply with respect to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

Section 2(b) of the bill provides that provisions having the same effect as the amendments made by the bill to the Internal Revenue Code of 1954 are to be deemed to be included in the Internal Revenue Code of 1939, effective with respect to all taxable years to which the Internal Revenue Code of 1939 applies.

III. STATISTICAL STUDIES BY INTERNAL REVENUE SERVICE

A. GENERAL EXPLANATION

Statistics of Income which the Internal Revenue Service has prepared and published annually for over 40 years has become an essential part of the basic Federal data used by many governmental and private organizations and persons. Many of these users would like, however, to obtain additional items or classifications of data which are not published in Statistics of Income. States, for example, have requested additional information which can be obtained only from Federal income tax returns. Up to the present such information has been refused or, in rare instances, made available in part under cumbersome conditions. The reason is the Service is unable to receive payment for the additional work and, therefore, has no way of paying for the additional costs incurred by it in making the studies, etc. Instead, where payment is received the payment is

covered into the general miscellaneous receipts of the Federal Government. Similarly, private organizations and individuals engaged in research have also been refused information that they either cannot obtain from other sources or can obtain only at much greater cost from other sources.

Other Federal agencies already are authorized to receive reimbursement for statistical and other services similar to those of the Internal Revenue Service for which reimbursement would be provided by this bill. These agencies are the Bureau of the Census, the Department of Labor, and the Department of Health, Education, and Welfare. The Department of Labor has had the authority since 1934 to prepare certain statistical compilations from its records upon payment of the actual costs of the work by the persons requesting it. The Secretary of Labor commenting on the proposed legislation with respect to the Treasury Department indicated that in the case of the Department of Labor much valuable data has been compiled by it in this manner. As a result, the Department of Labor favored enactment of this legislation enabling the Treasury Department to perform similar services on such a basis. In this connection the Secretary of Labor noted that the proposed studies would be subject to existing laws and regulations regarding unauthorized disclosure of information.

Policy guidelines to be followed in carrying out reimbursable statistical studies, etc., already are provided by the Bureau of the Budget in its statement of principles which appears below. Among these principles is the requirement that no agency arrange for supplementary processing of statistical materials which would interfere with the regular statistical program of the agency. Also, these principles provide that an agency should only make those special tabulations as appear to be justified in light of the limitations of the data if these tabulations are to be available for general use, or possible publication. It is further provided that special tabulations are to be available for publication both by the Federal agency and the outside sponsor except where the data are not to be published and are to be used only for special analysis.

In view of the above considerations your committee has added a provision to this bill amending the Internal Revenue Code to authorize the Secretary of the Treasury or his delegate to make special statistical studies and compilations involving data taken from tax returns, declarations, etc., to engage in special studies or compilations jointly with parties making such a request, and to furnish transcripts of these special studies or compilations to the parties making the request where they pay the cost of the work performed.

The bill also authorizes the Secretary of the Treasury or his delegate to admit employees and officials of States, the Commonwealth of Puerto Rico, possessions of the United States, local governments of any of the above, the District of Columbia, or of foreign governments to training courses conducted by the Internal Revenue Service and to supply them with texts and other training aids. In this case the Secretary of the Treasury may require the payment of a reasonable fee not to exceed the cost of the training and training aids.

The bill also provides that the payments received for the special statistical studies, compilations and other services, and the payments received for supplying training and training aids, together with payments received for any other services performed by a State or Federal agency in supplying copies of data from tax returns, etc., is to be deposited in a separate account. This separate account is then to be used to reimburse the appropriations which bore the cost of the work or services "or to refund excess sums when necessary."

E. STATEMENT OF PRINCIPLES: AVAILABILITY OF FEDERAL STATISTICAL MATERIALS TO NONGOVERNMENTAL RESEARCH WORKERS

I. Federal statistical and administrative data-collection programs often produce records capable of valuable statistical analysis beyond that which can or should be carried out by the collecting agency or any other agency of the Federal Government. In order that the optimum benefit may be obtained from Federal data-collection activities it should be the policy of the Federal Government to allow and to encourage the further analysis of these materials, under appropriate arrangements, by or on behalf of nongovernmental research workers.

II. Although some general principles may be offered for the guidance of agencies with such statistical materials in making them available for further processing, each such agency must determine and assume responsibility for its

policies and procedures in the light of the nature of its program and data and the demands for its data.

III. No agency should enter into any arrangement for the supplementary processing of statistical materials, regardless of whether reimbursement is provided, which will interfere with the regular statistical program of the agency.

IV. In general, requests for further analysis of Government data should be met as fully as possible by making special tabulations to the specifications of outside users.

1. While a priority should be given to bona fide research uses in the general public interest, special tabulations should be permissible for all legitimate uses, both public and private, including, for example, marketing studies.
2. The same rules for protecting confidentiality of individual responses must apply to special tabulations as are applied to the regular tabulation program.
3. The agency should make only such special tabulations as appear to it to be justified in the light of the limitations of the data when the tabulations are to be available for general use or possible publication. Less exacting standards are permissible only when the data are not to be published but used for special analysis by competent analysts fully aware of the limitations.
4. To the extent that special tabulations are deemed to serve a special, as distinguished from the general public, interest, the full costs shall be charged to the sponsors of the tabulation.
5. Special tabulations should be in the public domain, available for publication by both the Federal agency and the outside sponsor, except as provided in IV, 3, above.

V. Research needs which cannot be adequately served by special tabulations can under proper circumstances be met by allowing nongovernmental workers to work with the raw materials, worksheets, and other intermediate materials within the agency.

1. Such an arrangement is appropriate for research projects in the general public interest which would not be carried out without private sponsorship.
2. The agency should take appropriate steps to insure that candidates for this privilege meet appropriate standards of competence and integrity.
3. The agency should expect to instruct such workers as to the source, characteristics, and limitations of the data, and to cooperate with them, but it may properly set reasonable limits on the extent to which its own staff and facilities are committed to the project.
4. While the agency should give to the results of the research such technical review, from the point of view of presentation and use of agency data, as it deems feasible and appropriate, the agency assumes no responsibility for these results. Any publication based on them should include a clear disclaimer to that effect.
5. The agency should take whatever steps are necessary to protect the confidentiality of the data supplied by individual respondents, subject to the usual penalties for disclosure and other requirements of the agency law.

VI. Under extraordinary circumstances an agency may make available to outside research workers copies of original data or intermediate materials which involve no disclosure of confidential data for further processing outside the agency. This arrangement is appropriate only for studies clearly in the public interest, too complex to be carried on under other arrangements, to be carried out by workers of known competence to make valid use of the materials, working in close cooperation with the agency staff.

VII. Appropriate advance planning by agencies will promote maximum exploitation of data collected by the Federal Government by one or another of the above methods. Anticipation of demands for further tabulations beyond those planned for publication may be reflected in questionnaire design, card design, and tabulation procedures. The relatively few surveys which lend themselves to duplication of original materials for use outside the agency can probably be identified in advance, so that planning may take this use into account. In general, any steps to make the survey procedure a matter of systematic record, intelligible to other competent research workers, will aid users to make valid use of the data.

IV. ALLOWANCE OF REFUND WHERE TAX COURT HAS ACQUIRED JURISDICTION OF SUIT FOR REFUND

Generally under present law if the taxpayer decides to have his case determined by the district court or Court of Claims, he must pay the income tax in question and sue for a refund. On the other hand, if the Internal Revenue Service asserts a deficiency, the taxpayer may file a petition in the Tax Court and the case is then tried in that court without payment of the tax.

A problem has arisen as a result of this difference in jurisdiction in the case of refunds and deficiencies. Present law provides that if a taxpayer files a timely refund claim or timely suit for refund of taxes in a district court or Court of Claims, if subsequently the Government sends a notice of deficiency to such taxpayer with respect to the same tax and year and a petition is filed in the Tax Court, the proceedings on the two issues are to be tried together in the Tax Court, and the district court or Court of Claims loses jurisdiction over the suit for refund (sec. 7422(e) of the code).

The problem arises because a section of present law (sec. 6512(b)(2)) has been interpreted by some as meaning that where the Tax Court finds an overpayment was made, the refund must be limited to the total of (1) the amounts paid after the mailing of the notice of deficiency and (2) the amounts paid before the mailing of the notice of deficiency where a valid claim for refund could have been filed on the date of this mailing. The problem which arises is whether any refund can be made if at the time the Government's deficiency notice was mailed the taxpayer had previously filed a claim for refund and could not on that date have filed such a claim. Situations of this type are likely to occur, for example, where the deficiency can be asserted under the 6-year statute of limitations, because the amount asserted as omitted from gross income equals 25 percent or more of the total income involved.

This result could not have occurred under the 1939 Code and, although language changes were made when the 1954 Code was enacted, there is no indication that any change in this respect was intended. The committee reports on the section of the code in question (sec. 6512), for example, indicate that the section contains no material change from the 1939 Code although some clarifying changes were made. Since the 1954 enactment, moreover, the Internal Revenue Service has in practice interpreted the law as permitting the refund of amounts where valid claims have been timely filed, as well as where these claims could have been filed on the date of the mailing of the notice of deficiency.

Your committee believes it is desirable to amend the language of present law (sec. 6512(b)(2)) to make it clear that the statute conforms with the interpretation of this section followed by the Service since the enactment of the 1954 Code.

The bill amends present law (sec. 6512(b) (2)) to expressly allow a credit or refund of any portion of the tax where the Tax Court determines that this portion of the tax was paid within the appropriate period (as provided by sec. 6511 (b) (2), (c), or (d)) and with respect to which a timely claim for refund has been filed before the date of the mailing of a notice of deficiency. However, this claim for refund must not have been disallowed before the date of the mailing of the deficiency notice, or if it was, it must have been possible for a timely suit for refund to have been commenced on that date or it must be the subject of a suit for refund which had been commenced before that date (and within the period specified in sec. 6532, relating to the periods of limitations on suits for recovery of any internal revenue tax, penalty, or other sum).

The application of this amendment can be illustrated by the following examples:

Example 1.—X, a taxpayer files an income tax return for 1961 and pays the tax on April 15, 1962. On March 15, 1965 (within the 3-year period of limitations set forth in sec. 6511(a), for filing claims for refund), X files a claim for refund of $1,000 relating to the April 15, 1962, return. On October 1, 1965, a notice of deficiency is mailed to the taxpayer. In the October 1, 1965, deficiency letter, the Commissioner alleges that X has failed to report 25 percent or more of his gross income in the April 15, 1962, return of tax, thus permitting the Service to assert a deficiency within 6 years of the date the return was filed. X petitions for a redetermination of his tax for 1961 in the Tax Court, and the Tax Court sustains him, finding an overpayment of $1,000. Under new subparagraph (C)(i), X will recover the $1.000 since his refund claim was filed within the 3-year period set forth in sectioin 6511(a) and before the date of the

mailing of the notice of deficiency and since the claim was not disallowed before such date.

Example 2.—Assume the facts are the same as in example 1, and assume further that X's claim for refund had been disallowed on September 1, 1965. Since X's claim had been disallowed before the mailing of the notice of deficiency (on October 1, 1965), and since under section 6532 of the code, X has until September 1, 1967, to file a timely suit for refund, the provisions of new subparagraph (C)(ii) will permit X's overpayment to be refunded to him.

Example 3.—Assume the facts are the same as in examples 1 and 2 and that on September 15, 1965, X commences suit for refund of the tax in a district court. After the notice of deficiency is mailed to him on October 1, 1965, X files a petition with the Tax Court, with the result that under provisions of section 7422(e), jurisdiction of the entire subject matter of X's suit in the district court becomes lodged in the Tax Court. Since X has commenced suit before the mailing of the notice of deficiency and prior to September 1, 1967, his refund suit is timely and under provision of new subparagraph (C)(iii) refund of the entire $1,000 overpayment may be made.

V. COOPERATIVE BANKS

Under present law cooperative banks, together with domestic building and loan associations and mutual savings banks are allowed additions to a reserve for bad debts. Under present law this addition may represent the entire taxable income of the organization or an amount which will bring surplus, undivided profits, and reserves at the beginning of the year up to 12 percent of total deposits or withdrawable accounts at the end of the year.

The revenue bill of 1962, which has been passed by both the House and Senate and on which the conference has been held, modifies substantially the provision relating to additions to reserves for bad debts allowed cooperative banks, domestic building and loan associations, and mutual savings banks. In general terms, this bill as passed by Congress would allow a deduction for these institutions equal to whichever of the following is the greatest:

(1) Sixty percent of taxable income for the year computed before a bad debt deduction;

(2) An amount sufficient to bring the balance of the reserve for losses on qualifying real property loans to 3 percent of such loans outstanding at the close of the taxable year (up to 5 percent in the case of certain new companies), plus an amount sufficient to bring the balance of the reserve for losses on other loans up to a reasonable amount; or

(3) If the institutions demonstrate a need for a reserve greater than is permissible under the other two, an amount sufficient to bring the overall balance of its reserves up to a "reasonable" amount.

The deductions specified above are limited in that if the taxpayer uses alternatives Nos. (1) or (2), the deduction allowed may not increase the reserve for losses on qualifying real property loans, together with the reserve for losses on nonqualifying loans and surplus, undivided profits, and other reserves to more than 12 percent of total deposits or withdrawable accounts. In addition, no deduction may be taken under alternative No. 1 described above to the extent that such a deduction would increase the reserve for losses on qualifying real property loans to more than 6 percent of these loans.

The revenue bill of 1962 also contains a definition of a domestic building and loan association which must be met before one of these institutions is eligible for the preferred deduction for an addition to reserves, as described above.

In adopting the definition for a domestic building and loan association in the revenue bill of 1962, the report of your committee indicated that there had been problems with the definition in present law because loans in many cases now are in substance not loans made to members. It was indicated that technical conformance has been maintained with the membership requirement of present law by making borrowers of funds, members of the institutions. Nevertheless, questions have been raised as to the substance of these provisions. In this respect the report of your committee on the revenue bill of 1962 stated as follows:

> As a result, your committee has concluded that the definition of a domestic building and loan association, eligible for the tax treatment described above, should be brought more nearly into conformance with actual practice. At the same time it was deemed desirable to restrict this tax treatment to those

primarily engaged in making residential real estate loans, with special emphasis on 1- to 4-family units, and omitting from the definition cases such as those where these institutions have been used for speculative purposes.

As a result, the revenue bill of 1962 defines a domestic building and loan association as one which meets a series of requirements set forth in that bill. No reference is made in this regard, however, to a cooperative bank. Although the bill permits a cooperative bank the same deduction as a domestic building and loan association, it provides no specific definition of what constitutes a cooperative bank. Generally it is understood that cooperative banks are essentially the same type of organization and carrying on essentially the same type of activity as a domestic building and loan association. This is indicated, for example, in a State court case wherein it is stated with respect to a domestic building and loan association:

> The business of the association is substantially similar to that conducted by our State chartered cooperative banks. Both appeal to the same type of investor and to the same class of borrowers. Their investments and loans are practically identical in character (*Commissioner of Corporations and Taxation* v. *Flaherty*, 306 Mass. 461, 28 N.E. 2d 433, cert. denied, 312 U.S. 680).

The desirability of providing the same restrictions for cooperative banks as for domestic building and loan associations is a matter which it is understood was recognized by the conferees on the part of the House and Senate on the revenue bill of 1962. However, because a new definition applicable to cooperative banks was not a matter which was in conference on that bill, no action could be taken on this matter at that time.

In view of the considerations set forth above, your committee has concluded that it is desirable to amend the law to provide essentially the same definition for a cooperative bank as the revenue bill of 1962 will provide in the case of domestic building and loan associations. This provision which makes such a definition applicable to cooperative banks, before they may qualify for the special deduction for additions to bad debt reserves, is to be effective with respect to such institutions for taxable years beginning after the date of enactment of the Revenue Act of 1962.

This section provides that cooperative banks are those without capital stock and operated for mutual purposes and without profit which meet two sets of conditions which the revenue bill of 1962 makes applicable in the case of domestic savings and loan associations. The first set of requirements is that the cooperative bank be an insured institution within the meaning of section 401(a) of the National Housing Act or one which is subject by law to supervision and examination by State or Federal authority having supervision over such banks. The second set of requirements is that the cooperative bank must meet the same requirements as are set forth in subparagraphs (B), (C), (D), (E), and (F) of paragraph (19) of section 7701(a) of the code as provided by the revenue bill of 1962 for domestic building and loan associations.

The first of these provisions provides that a cooperative bank qualifies only if substantially all of its business consists in accepting savings and investing in loans secured by, or for the improvement of, real property described below. This restriction is not designed to prevent a cooperative bank from buying or selling participations in its other loans but it is anticipated that this will prevent a cooperative bank from carrying on the business of brokerage mortgage paper if this represents any substantial part of its business. Moreover, it is not intended that this prevent necessary or desirable borrowings from Government agencies.

Another restriction on qualified cooperative banks requires them to invest at least 90 percent of their assets in—

(1) Cash,

(2) Obligations of the United States or of a State or local government, stock or obligations of a corporate instrumentality of the United States or of a State or local governmental unit, and certificates of deposits in, or obligations of, a corporation organized under a State law which specifically authorizes the corporation to insure the deposits (or share accounts) of member cooperative banks,

(3) Loans secured by an interest in real property, including so-called improvement loans,

(4) Loans secured by a deposit (or share) of a member,

(5) Property acquired through the default of real property loans, and

(6) Property used by the cooperative bank in the conduct of its qualified business.

Of the 90 percent of total assets referred to above, at least 80 percent (72 percent of total assets) must be invested in—

(1) Loans secured by an interest in, or made for the improvement of, real property (including tract loans where the tract is to be improved),

(2) Loans secured by, or made for the improvement of, real property used primarily for church purposes,

(3) Cash,

(4) Obligations of the United States or of a State or local government, stock or obligations of a corporate instrumentality of the United States or of a State or local governmental unit, and certificates of deposit in or obligations of a corporation organized under a State law which specifically authorizes the corporation to insure deposits or share accounts of member cooperative banks,

(5) Loans secured by a deposit (or share) of a member,

(6) Property used by the cooperative bank in the conduct of its qualified business, and

(7) Property acquired through the default of any of the loans described above.

In addition, at least 60 percent of this 90 percent of total assets (54 percent of total assets) must be invested in loans secured by an interest in real property which is residential real property containing one- to four-family units (or loans made for the improvement of such property or tract loans with respect to such property), or for any of the purposes specified in Nos. 2 through 7 above.

The definition also provides that a qualifying cooperative bank may not invest more than 18 percent of its total assets in other than residential real property loans and categories Nos. 2 through 7 listed above. Similarly, the provisions provides that not more than 36 percent of the total assets may be invested in other than one- to four-family unit residential real property and categories Nos. 2 through 7 listed above. However, under some circumstances this "36 percent" requirement may be increased to as much as 41 percent. Where this occurs, however, the revenue bill of 1962 reduces the maximum allowable addition to the reserve for losses on qualifying real property loans, if either the 60 percent of taxable income or the 3 percent of reserves methods are used, according to the following table:

If the percentage exceeds—	But does not exceed—	The reduction shall be the following proportion of the amount otherwise determined—
36 percent	37 percent	1/12
37 percent	38 percent	1/6
38 percent	39 percent	1/4
39 percent	40 percent	1/3
40 percent	41 percent	5/12

A cooperative bank may qualify for the reduced deduction where it misses the "36 percent" requirement but comes within the range of the "41 percent" requirement only (1) in the cooperative bank's first taxable year beginning after the date of enactment of the revenue bill of 1962, or (2) if it met the 36 percent requirement for the immediately preceding year or (3) if it met at least the 41 percent requirement for the preceding year.

One further requirement provides that not more than 3 percent of the assets of the cooperative bank may be invested in stock of any corporation other than those listed in category No. 4 immediately above.

The percentages referred to above may be determined on the basis of the average assets outstanding during the taxable year or on the basis of those outstanding at the close of the taxable year.

VI. DEPARTMENTAL REPORTS

TREASURY DEPARTMENT,
Washington, September 20, 1962.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: This is in reference to H.R. 12599, now pending before your committee, to modify the income tax treatment of terminal railroad corporations and their railroad shareholders.

The purpose of this bill is to relieve the Chicago & Western Indiana Railroad Co., a terminal railroad corporation, and other terminal railroad corporations similarly situated, of the effect of the decision in *Chicago and Western Indiana Railroad Co.* v. *Commissioner*, C.A. 7th, May 1, 1962, 303 F 2d 796. The C. & W.I. Railroad Co., like most other terminal facilities which are jointly owned by railroads using the facility, operates under a common basic rental agreement between the facility and its railroad shareholders. Under this terminal-owner agreement, the C. & W.I. applied gross income obtained from concessions and the rendering of services to railroad users other than the shareholders, referred to herein as "nonowner income," against the cost of operation of the terminal facility, and the shareholders were obligated to make payment of the remaining deficit. In the above-cited case, the Court of Appeals for the Seventh Circuit declared an amount equal to this nonowner income was taxable to the terminal corporation under two theories: (1) That there was a constructive receipt by the terminal from its shareholders of an amount equal to the nonowner income credited to the shareholders, and (2) that to the extent of the nonowner income credited to its shareholders, the terminal may not treat its expenses in providing services and facilities to its shareholders as "ordinary and necessary" business expenses.

The tax consequences of the above decision, in addition to the taxation of the nonowner income to the terminal, are (1) that the shareholders become entitled to additional rental deductions equal to their respective shares of the cost of operating the facility which was defrayed by application of the nonowner income, and (2) the shareholders are considered to have received constructive dividends equal to the nonowner income so applied. Only 15 percent of the constructive dividends would be includible by the shareholders in view of the 85-percent intercorporate dividend deduction.

Normally the increase in tax to the terminal corporation attributable to inclusion of the nonowner income would be offset by the reduction in tax to the shareholders attributable to the additional rental deductions, except for the tax on the 15-percent intercorporate dividend. However, in the case of the Chicago & Western Indiana Railroad Co., the shareholder railroads had substantial and continuing operating losses for most of the taxable years involved. Thus, the additional rental deductions to them would be wasted. Pursuant to their obligations as guarantors of liabilities of the C. & W.I., the shareholder roads would have to make up the additional taxes imposed on C. &. W.I. of approximately $12 million with no effective offset in their own tax liabilities. Evidence has been presented that imposition of this additional financial burden may result in bankruptcy of one or more of the shareholders roads.

It has come to our attention that in the case of some other terminal corporations the shareholder railroads would be entitled to refunds by virtue of the additional rental deductions under the above decision, but the United States would not be able to collect the offsetting additional taxes from the terminal corporation. This situation arises because the statute of limitations has run as to most terminal corporations for years prior to 1958 whereas the taxable years of most of the shareholder roads are still in the process of audit for several years prior to 1958. This windfall to certain shareholder railroads could involve a substantial revenue loss.

The Department believes a legislative solution should be found to the problems arising as a result of the decision in *Chicago & Western Indiana Railroad Co.* which does not impose serious financial burdens on the shareholder railroads as a consequence of required terminal operations, both prospectively and retroactively, and which will prevent windfall refunds to certain shareholder railroads as above described. The Department has cooperated with representatives of the railroad industry, and particularly with representatives of the shareholder

railroads of the Chicago & Western Indiana Railroad Co., in working out the solution presently embodied in H.R. 12599, which it is believed will attain the above objectives.

Essentially the bill provides for income tax treatment of railroad terminals and their shareholder railroads which is comparable to the tax practice of such terminals and shareholders prior to the decision in *Chicago & Western Indiana Railroad Co.* Thus, where a terminal railroad corporation offsets a charge for services performed for a railroad shareholder, by crediting railroad terminal income against this charge, the terminal railroad corporation is not to be treated as having received the portion of the charge so offset, nor is this portion to be rendered taxable to the terminal railroad corporation through the disallowance of deductions. The railroad shareholder is not to be taxed on the portion of the charge satisfied with the terminal income nor is it to receive a deduction as having paid such portion.

The bill limits the benefit of the above rule to the crediting of "related terminal income" which concept, as defined in the bill, includes nearly all terminal railroad income today but acts as a limitation to prevent possible abuse of this provision in the future. The bill also requires that the crediting against the shareholder liability must be pursuant to written agreement, which is in accord with prior practice of the terminal railroads and their shareholders, and the liability must be for services, or the use of facilities, taken into account in computing related terminal income.

The amendments made by H.R. 12599 are to apply with respect to all taxable years subject to the Revenue Code of 1954 and to years subject to the Internal Revenue Code of 1939. In this connection a question has arisen as to whether the retroactive application of these amendments is constitutional. Although it is believed that the retroactive application of these amendments is constitutional, the question is not entirely free from doubt. Under these circumstances, the Department suggests it may be desirable to modify slightly the retroactive application of the bill. A suggested amendment to accomplish this objective is attached hereto for your consideration.

For the reasons stated above, the Department favors enactment of H.R. 12599.

The Bureau of the Budget has advised the Treasury Department that there is no objection from the standpoint of the administration's program to the presentation of this report.

Sincerely yours.

STANLEY S. SURREY,
Assistant Secretary.

PROPOSED AMENDMENT TO SECTION 281

Redesignate subsection (e) as subsection (f), and in lieu thereof insert the following:

(e) *Application to taxable years ending before the date of enactment.*— In the case of any taxable year ending before the date of the enactment of this section—

(1) this section shall apply only to the extent that the taxpayer computed on its return, filed at or prior to the time (including extensions thereof) that the return for such taxable year was required to be filed, its taxable income in the manner described in subsection (a) in the case of a terminal railroad corporation, or in the manner described in subsection (b) in the case of a shareholder of a terminal railroad corporation; and

(2) this section shall apply to a taxable year for which the assessment of any deficiency, or for which refund or credit of any overpayment, whichever is applicable, was prevented, on the date of the enactment of this section, by the operation of any law or rule of law (other than section 3760 of the Internal Revenue Code of 1939 or section 7121 of the Internal Revenue Code of 1954, relating to closing agreements, section 3761 of the Internal Revenue Code of 1939 or section 7122 of the Internal Revene Code of 1954, relating to compromises, and other than a decision of the Tax Court entered pursuant to a stipulated settlement), only—

(A) to the extent any overpayment of income tax would result from the recomputation of the taxable income of a terminal railroad corporation in the manner described in subsection (a),

(B) if claim for credit or refund of such overpayment, based upon such recomputation, is filed prior to one year after the date of the enactment of this section,

(C) to the extent that paragraph (1) applies, and

(D) if each shareholder of such terminal railroad corporation consents in writing to the assessment, within such period as may be agreed upon with the Secretary or his delegate, of any deficiency for any year to the extent attributable to the recomputation of its taxable income in the manner described in subsection (b) correlative to its allocable share of the adjustment of taxable income made by the terminal railroad corporation in its recomputation under subparagraph (A).

TREASURY DEPARTMENT,
Washington, September 27, 1962.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your request for this Department's views on H.R. 12030, a bill to amend the Internal Revenue Code of 1954 with respect to moneys received in payment for special statistical studies and compilations and certain other services.

This bill incorporates the substance of a draft of proposed legislation submitted by the Secretary of the Treasury on Feburay 1, 1962, to the Speaker of the House of Representatives and to the President of the Senate. The purpose of this proposed legislation is to permit moneys received in payment for certain services rendered by the Internal Revenue Service on request to be deposited in a separate account which may be used to reimburse appropriations which bore the expense of such services. Under existing law, amounts received in reimbursement for such services must be paid into the Treasury of the United States as internal revenue collections and, since the Service is not able to use these amounts, the full cost of such services must be charged to appropriations. Consequently, many requests for authorized special services on programs for which demand is irregular and unpredictable, although of a worthy nature, must be denied by the Service.

The proposed legislation would remove existing obstacles to performance by the Service of many of the requests received by it for the services to which the legislation applies. Such services include special statistical studies and compilations involving data available in connection with the statistics published annually by the Service, the furnishing of instruction to those employees and officials of States and other governmental entities admitted to the training courses of the Service, and the supplying of texts and other training aids for the use of such governmental entities; and furnishing to States or departments or agencies of the Federal Government of copies of, or data from, returns, statements, or other documents filed under authority of the code and of records maintained by the Service in connection with the administration of the code.

This bill was reported favorably on September 14, 1962, by the Committee on Ways and Means, but the House of Representatives has not yet had time to consider the bill. The Treasury Department recommends enactment of the provisions of this bill during this Congress. Therefore, we request that you add the provisions of this bill to H.R. 12599, to modify the income tax treatment of terminal railroad corporations and their railroad shareholders, which is now pending before your committee.

The Bureau of the Budget has advised the Treasury Department that there is no objection from the standpoint of the administration's program to the presentation of this report.

Sincerely yours,

STANLEY S. SURREY,
Assistant Secretary.

TREASURY DEPARTMENT,
Washington, September 17, 1962.

HON. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: A procedural defect in the provisions of the Internal Revenue Code, which could have the effect of barring the payment of an otherwise valid and timely claim for refund, recently has been called to the attention of the Treasury Department. This situation can arise where the Tax Court acquires jurisdiction of a taxpayer's timely suit for refund pursuant to section 7422(e) of the code, decides the refund issue favorably to the taxpayer, but the overpayment so determined cannot be allowed by reason of a technical and presumably unintended deficiency in the wording of section 6512(b)(2) of the code.

Section 6512(b)(2) provides that no refund of an overpayment determined by the Tax Court shall be allowed unless the Tax Court also determines that the overpayment was paid either (1) after the mailing of the notice of deficiency which originally gave jurisdiction to the Tax Court, or (2) at such a time that the taxpayer could have filed a timely claim for refund on the date the notice of deficiency was mailed. This provision works satisfactorily in all cases except where the period of limitations on the Commissioner's right to issue a deficiency is longer than the period of limitations on filing a claim for refund. In the latter case, however, a refund based on a timely claim may be barred by the technical wording of section 6512(b)(2) because, even though an actual claim for refund was filed before the mailing of the notice of deficiency, the period of limitation on filing a claim may have expired at the time the notice of deficiency was mailed. The Internal Revenue Service has examined this matter and, although it is not aware of any case where a taxpayer has been denied a refund due to this defect, the Service agrees that a literal reading of section 6512(b)(2) would require this unfortunate result.

This result could not have occurred under the 1939 code because the provisions of section 7422(e), which were designed to prevent the concurrent jurisdiction in tax disputes of the Tax Court on the one hand and the various district courts and the Court of Claims on the other, were first enacted in the 1954 code. The language of section 6512(b)(2), however, was not technically refined sufficiently to accommodate this change in procedure.

We are informed that a case has arisen in which a taxpayer's timely claim for refund may be barred by the operation of this technical defect unless corrective legislation is enacted. The Treasury Department believes that such legislation merits favorable consideration by the Congress.

Enclosed for your consideration is a draft of an amendment to section 6512(b)(2) which is designed to correct this defect.

The Bureau of the Budget has advised the Treasury Department that there is no objection from the standpoint of the administration's program to the presentation of this report.

Sincerely yours,

STANLEY S. SURREY
Assistant Secretary.

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[H.R. 12599] [23]

INCOME TAX TREATMENT OF TERMINAL RAILROAD CORPORATIONS

[Conference Report No. 2543, Eighty-seventh Congress, Second Session]

[OCTOBER 5, 1962]

MR. MILLS, from the committee of conference, submitted the following conference report to accompany H.R. 12599.

The committee of conference on the disagreeing votes of the two Houses on the amendments of the Senate to the bill (H.R. 12599) relating to the income tax treatment of terminal railroad corporations and their shareholders, having

[23] Public Law 87-870, page 213, this Bulletin.

met, after full and free conference, have agreed to recommend and do recommend to their respective Houses as follows:

That the House recede from its disagreement to the amendments of the Senate numbered 1, 2, 3, 4, 5, 6, and 7 and agree to the same.

That the House recede from its disagreement to the amendment of the Senate to the title of the bill and agree to the same.

W. D. MILLS
CECIL R. KING,
HALE BOGGS,
NOAH MASON,
JOHN W. BYRNES,
Managers on the Part of the House.
HARRY F. BYRD,
ROBT. S. KERR,
RUSSELL LONG,
JOHN J. WILLIAMS,
CARL T. CURTIS,
Managers on the Part of the Senate.

STATEMENT OF THE MANAGERS ON THE PART OF THE HOUSE

The managers on the part of the House at the conference on the disagreeing votes of the two Houses on the amendments of the Senate to the bill (H.R. 12599) relating to the income tax treatment of terminal railroad corporations and their shareholders, submit the following statement in explanation of the effect of the action agreed upon by the conferees and recommended in the accompanying conference report:

SECTIONS 1 AND 2. TERMINAL RAILROAD CORPORATIONS

The bill as passed by the House provided rules for the computation of the taxable income of certain railroad terminal corporations and their shareholders. The new treatment under the bill was applicable to all years to which the Internal Revenue Code of 1954 or the Internal Revenue Code of 1939 applies.

Senate amendment No. 3, and the conference agreement, provide additional rules relating to the application of the bill in the case of taxable years ending before the date of the enactment of the bill. The House recedes.

Senate amendments Nos. 1 and 2, and the conference agreement, also make technical changes to permit the application of section 281 to certain corporations which are common parent corporations and to certain corporations having short taxable years. The House recedes.

SECTION 3. STATISTICAL STUDIES, ETC.

Senate amendment No. 5, and the conference agreement, amend the Internal Revenue Code of 1954 to authorize the Secretary of the Treasury or his delegate to make special statistical studies and compilations involving data taken from tax returns, declarations, etc., to engage in special studies and compilations jointly with parties making such a request, and to furnish transcripts of these special studies and compilations to the parties making the request where they pay the cost of the work performed.

Amendment No. 5, and the conference agreement, also authorize the Secretary of Treasury or his delegate to admit employees and officials of States, the Commonwealth of Puerto Rico, possessions of the United States, local governments of any of the above, the District of Columbia, or of foreign governments to training courses conducted by the Internal Revenue Service and to supply them with texts and other training aids. In this case the Secretary of the Treasury may require the payment of a reasonable fee not to exceed the cost of the training and training aids.

Amendment No. 5, and the conference agreement, also provide that payments for work or services performed—

(1) pursuant to the new section 7515 (pecial statistical studies and compilations),

(2) pursuant to the new section 7516 (supplying of training and training aids), and

(3) for a State or a department or agency of the Federal Government in supplying certain copies and data,

are to be deposited in a separate account. This separate account may be used to reimburse appropriations which bore all or part of the costs of such work or services, or to refund excess sums when necessary.

The House recedes on Senate amendment No. 5.

SECTION 4. ALLOWANCE OF CERTAIN REFUNDS

Senate amendment No. 6, and the conference agreement, make a technical amendment to section 6512(b)(2) of the Internal Revenue Code of 1954 (relating to limit on amount of credit or refund of overpayment determined by the Tax Court).

The House recedes.

SECTION 5. COOPERATIVE BANKS

Senate amendment No. 7, and the conference agreement, in effect provide that for cooperative banks to qualify for the special bad debt reserve provisions of section 593 of the code (as amended by sec. 6 of the Revenue Act of 1962) they must meet essentially the same requirements as to the character of their investments as are provided for domestic building and loan associations. The House recedes.

W. D. MILLS,
CECIL R. KING,
HALE BOGGS,
NOAH MASON,
JOHN W. BYRNES,
Managers on the Part of the House.

[H.R. 13358] [24]

TAXABLE YEAR FOR THE DEDUCTION OF INTEREST BY CERTAIN SAVINGS INSTITUTIONS

[House Report No. 2544, Eighty-seventh Congress, Second Session]

[October 6, 1962]

Mr. MILLS, from the Committee on Ways and Means, submitted the following report to accompany H.R. 13358.

The Committee on Ways and Means, to whom was referred the bill (H.R. 13358) relating to the taxable year for which the deduction for interest paid will be allowable to certain building and loan associations, mutual savings banks, and cooperative banks, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

I. SUMMARY OF BILL

This bill provides in general that mutual savings banks, savings and loan associations, and cooperative banks will not be allowed in any one year income tax deductions for interest payments to depositors (or for dividend payments to shareholders) which are attributable to more than a 12-month period. This applies for taxable years ending after December 31, 1962. This is intended to prevent the possible avoidance of the new tax provisions applicable to these institutions for 1963 and subsequent years by "bunching" in 1963, or a subsequent year, interest (or dividend) payment deductions attributable to more than a 12-month period.

The Treasury Department has urged the enactment of this provision and this bill was reported unanimously by your committee.

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[24] The provisions of H.R. 13358 were incorporated in H.R. 6371, passed as Public Law 87–876, page 217, this Bulletin.

II. GENERAL STATEMENT

Prior to the passage by Congress of section 6 of H.R. 10650 (which has been passed by both the House and the Senate but not yet signed by the President) mutual savings banks, domestic building and loan associations, and cooperative banks were permitted a deduction for special additions they were permitted to make to their bad debt reserves. This deduction may equal an institution's entire taxable income or an amount necessary to bring the sum of its surplus, undivided profits, and bad debt reserve up to an amount equal to 12 percent of total deposits, whichever is the lesser. Most of these institutions in practice have been able to deduct their entire taxable income since this is usually less than the amount necessary to bring their bad debt reserve up to an amount equal to 12 percent of total deposits. This is indicated by the fact that during the entire decade 1952–61, inclusive, all mutual savings banks and savings and loan associations paid total income taxes of less than $70 million while at the same time retaining $5.5 billion in additions to reserves, surplus, and undivided profits.

The Revenue Act of 1962 is intended to correct this situation for taxable years ending after December 31, 1962, by in general limiting the bad debt reserve deduction of these institutions to whichever of the following is the greatest:

(1) Sixty percent of taxable income for the year (computed before a bad debt deduction);

(2) An amount sufficient to bring the balance of the reserve for losses on qualifying real property loans to 3 percent of such loans outstanding at the close of the taxable year (up to 5 percent in the case of certain new companies), plus an amount sufficient to bring the balance of the reserve for losses on other loans up to a reasonable amount; or

(3) If the institutions demonstrate a need for a reserve greater than is permissible under the other two, an amount sufficient to bring the overall balance of its reserves up to a "reasonable" amount.

The Treasury Department has advised your committee that some of these savings institutions, in order to avoid the tax which becomes applicable to them for the first time in 1963, may postpone their last quarterly interest payment on deposits (or dividend payment on shares as it is called in some cases) for 1962, until 1963. The fact that these institutions take only three quarterly interest (or dividend) payment deductions in 1962 is not likely to increase their taxes for 1962, since they can in most cases adjust upward for 1962 the amount of their bad debt reserve deduction by the amount of the decrease in their interest (or dividend) deduction. However, by taking five, instead of four, quarterly interest (or dividend) deductions in 1963 they will for that one year be able in effect either to forestall, or hold to a low level, the increase in taxes which Congress by the passage of the Revenue Act of 1962 planned for 1963 and subsequent years.

The problem can be illustrated as follows: Assume a savings institution has net earnings before dividend or interest payments of $1 million both for 1962 and 1963. If the savings institution normally pays out $800,000 of these earnings to savers as interest or dividends, this would leave $200,000 of retained income in both years. For 1962 present law generally would permit the deduction of this entire $200,000 as a bad debt reserve deduction. However, for 1963 the Revenue Act of 1962 in most cases will provide a regular corporate tax on 40 percent of the retained earnings of $200,000.

If, instead of following its normal procedures, the institution postpones its last quarterly interest or dividend payment for 1962 until 1963, its deduction for interest or dividend payments for 1962 will be $600,000 rather than $800,000. However, in most cases the bad debt reserve deduction can be increased from $200,000 to $400,000 with the result that no tax is imposed for 1962. However, by "bunching" into 1963, the extra $200,000 interest or dividend deduction, together with the regular four quarterly payments of $200,000 each, the institution obtains interest or dividends deductions in 1963 of $1 million, rather than the $800,000 which would occur under normal procedures. In this manner instead of paying tax on 40 percent of $200,000 for 1963, the institution need pay no tax at all.

Information obtained from the Federal Home Loan Bank Board indicates that there are little or no supervisory restrictions which would prevent the deferral of yearend dividends in the manner indicated. In fact, it appears that several

associations employed this procedure recently when, for technical reasons, it resulted in a savings in insurance premiums to the Federal Savings and Loan Insurance Corporation.

The possibility of these institutions bunching deductions also exists where they already pay their yearend dividends in January. In such a case at the end of 1963, instead of 1962, these institutions could obtain an extra deduction for 1963 by paying their last quarterly interest or dividend payment on December 31, 1963, rather than in January 1964, and then by maintaining this procedure for subsequent years.

The staff of the Joint Committee on Internal Revenue Taxation has estimated that the provisions in the Revenue Act of 1962 relating to mutual savings banks, building and loan associations, and cooperative banks will increase revenues by $170 million in the first full year of operation. The Treasury Department has estimated that this revenue increase will amount to $200 million. The Treasury Department has indicated that failure to enact a provision of the type provided by this bill could result in a loss of well over half of the revenue for 1 year, namely, over $85 to $100 million of this $170 to $200 million.

To prevent tax manipulation of the type referred to above, your committee's bill adds a new paragraph to section 461 of the code, dealing with accounting rules specifying the year such deductions are to be taken. The new subsection provides that except as otherwise provided in regulations prescribed by the Secretary of the Treasury or his delegate, amounts paid or credited to the accounts of depositors as interest (or to holders of shares as dividends) by mutual savings banks, domestic building and loan associations, and cooperative banks are not to be allowed as deductions for any taxable year, to the extent the amounts paid or credited are for periods representing more than 12 months. In any case, where an interest or dividend payment deduction is denied under this provision, it is provided that the Secretary of the Treasury or his delegate is to allow the excess deduction denied in that year in such other taxable year as he "determines to be consistent with the preceding sentence." By this it is meant that he is to allow the deduction in another year where this excess deduction, together with the deductions otherwise allowable in the year in question, do not bring the total deductions for that year to a total representing a period of more than 12 months. It is contemplated that in any cases involving a short year, the Secretary will use his regulatory authority already available to prevent the deduction in such years for periods in excess of the appropriate number of months, or portions of months. Regulatory authority is left with the Secretary of the Treasury to permit the taking of deductions for more than a 12-month period in any year, and it is contemplated that he will permit such deductions in any case where it is established to his satisfaction that the institution does not intend to avoid taxes, and does not achieve any appreciable tax reduction by the timing of the deduction.

This provision is to apply to taxable years ending after December 31, 1962.

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[H.R. 6371] [25]

LIMITATION ON RETIREMENT INCOME CREDIT

[Senate Report No. 2202, Eighty-seventh Congress, Second Session, Calendar No. 2165]

[September 29, 1962]

Mr. Byrd of Virginia, from the Committee on Finance, submitted the following

The Committee on Finance, to whom was referred the bill (H.R. 6371) to amend section 37 of the Internal Revenue Code of 1954 with respect to the limitation on retirement income, having considered same, report favorably thereon without amendment and recommend that the bill do pass.

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[25] Public Law 87-876, page 217, this Bulletin.

I. SUMMARY

The retirement income credit under present law is designed to give those who have retirement income, but do not receive tax-exempt social security or similar types of tax-exempt benefit payments, a tax exemption of approximately the same size as that received by social security beneficiaries. Although at one time the terms of the retirement income credit corresponded approximately with those of the social security benefits, as changes have been made in the social security program corresponding changes have not always been made in the retirement income credit. This bill updates the credit in this respect, first by raising the maximum amount of retirement income which may be taken into account from $1,200 to $1,524 (as under present law this will continue to be multiplied by the first bracket tax rate of 20 percent to determine the credit). Second, instead of earned income in excess of $1,200 reducing the retirement income eligible for the credit on a dollar-for-dollar basis, such a dollar-for-dollar reduction will occur only for earnings above $1,700. For earnings between $1,200 and $1.700, the retirement income will be reduced by 50 cents for every dollar of earnings. Third, for those retiring under public retirement programs, this new reduction for earned income will apply to those age 62 or over rather than 65 or over as under present law. (For those under a public retirement program below age 62, the present $900 floor for a reduction arising from earned income will continue to apply.)

II. GENERAL STATEMENT

In 1954 Congress added to the tax laws the retirement income credit. As indicated in the report made on the bill at that time the credit was added because—

> Under existing law benefits payable under the social security program and certain other retirement programs of the Federal Government are exempt from income tax. Your committee believes that the tax-exempt status of such benefits discriminates against persons receiving retirement pensions under other publicly administered programs, such as teachers, as well as against persons who receive industrial pensions or who provide independently for their old age.

In view of this situation, Congress provided a credit against tax which in effect allowed an exemption of retirement income (at the first tax bracket rate) patterned along the lines of the social security benefits then payable, but available to individuals only to the extent that they do not receive social security, railroad retirement, or other similar tax-exempt forms of income.

Because this credit was designed in effect to give those not receiving social security, railroad retirement, and other forms of tax-exempt income tax exemption on their passive investment income to the same extent as those receiving social security benefit payments, any of the salient features of the credit were designed along the lines of the social security program.

The forms of retirement income eligible for this credit are pensions and annuities, interest, rents, and dividends.

In addition to the retirement income credit generally available, such a credit, subject to added restrictions as to earnings, was also made available in 1954 to those under age 65 receiving income from pensions and annuities under a public retirement system.

Since the last amendments to the retirement income credit in 1956, there have been a number of changes made in the social security program. As a result, the retirement income credit no longer provides equal tax treatment for those who may be retired under Government or private pension systems or may make provision through investment income for their own retirement. This bill is designed to remove this discrimination which has arisen gradually as changes have been made in the social security program without corresponding changes in the retirement income credit.

To again equalize the retirement income credit with the social security program, three changes are made:

First, the maximum amount of income which may qualify as retirement income is raised from $1,200 to $1.524 a year. This latter figure corresponds exactly with the maximum primary benefit ($127 a month) now available under the social security program. To determine the maximum retirement income credit, the $1,524 must be multiplied by 20 percent. Thus there will be a maximum

credit of $304.80 per person under the bill as contrasted to $240 under present law.

Second, the reduction made in the retirement income credit for earned income is changed to correspond with the changes made in the earned income reduction provided by the Social Security Amendments of 1960 and 1961. Thus, instead of all earnings above $1,200 reducing the amount eligible for the retirement income credit on a dollar-for-dollar basis, earnings between $1,200 and $1,700 a year are to reduce the retirement income credit by a half dollar for every dollar of earnings in this bracket. For income above $1,700, there will still be the dollar-for-dollar reduction.

Third, because of the change in the social security age requirement from 65 to 62, for those retired under public retirement systems who are in the age bracket 62 to 65, the level of earned income where the reduction in retirement income begins is increased from the $900 level provided by present law to $1,200, with the one-half-for-one reduction in the bracket between $1,200 and $1,700 referred to above.

The eligibility age for the retirement income credit generally, was not reduced from 65 to 62 because, although it is now possible for men to retire at this age under the social security program, they are not at that time eligible for the full social security benefit payments.

The changes made by the bill can be illustrated by an example. Assume an individual between ages 65 and 72 receives $2,000 from dividends, interest, and a pension provided exclusively by his employer. Assume further that he receives $1,800 from working in a part-time job. Assume also that he had earnings of more than $600 in each of 10 prior years. In this case his retirement income credit under present law and under this bill can be computed as follows:

	Present law	Committee bill
1. Retirement income to be taken into account: $1,200 under present law or $1,524 under bill or actual amount ($2,000 in this case) whichever is less	$1,200	$1,524.00
2. Less earned income over $1,200 under present law or under bill ½ of earnings between $1,200 and $1,700 and all earnings over $1,800 (present law = $1,800—$1,200; bill = ½ of earnings between $1,200 and $1,700 plus the $100 over $1,700)	600	350.00
3. Retirement income eligible for credit	600	1,174.00
4. Credit: 20 percent of amount on line 3 [1]	120	234.80

[1] Assumes this is not less than tax as otherwise computed.

It is estimated that the changes made by this bill will result in an annual revenue loss of something like $30 million a year.

DEPARTMENTAL REPORT

TREASURY DEPARTMENT,
Washington, May 14, 1962.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

MY DEAR MR. CHAIRMAN: This is in response to a request for the views of this Department on H.R. 6371, to amend section 37 of the Internal Revenue Code of 1954 with respect to the limitation on retirement income.

The retirement income credit was designed, in effect, to give those who have retirement income a tax exemption similar to that received by social security beneficiaries, whose benefits are not considered part of their gross income and are therefore tax exempt. To achieve this purpose, Congress enacted section 37 of the Internal Revenue Code of 1954. This measure allows a retired individual a tax credit, computed at the first bracket rate of 20 percent, on the amount of his otherwise taxable retirement income up to a maximum of $1,200. The $1,200 maximum was selected to correspond, roughly, to the maximum primary social security benefit which could be paid at the time. To prevent the duplication of relief, amounts received from nontaxable pensions and

annuities, including social security benefits, must be subtracted from the maximum figure before computing the credit. The credit may not exceed the tax liability of the individual.

The retirement income credit, like the social security program, was intended for the benefit of retired persons. Section 37 as first enacted contained essentially the same test of retirement as was then employed for the purpose of social security. The income eligible for credit in the case of persons under 75 was reduced by the amount of earnings in excess of $900. Section 37 was amended in 1956 so that the earnings limit for the retirement test would conform to the revised limit adopted in the 1954 amendments to the Social Security Act. The age level at which the earnings limitation ceased to apply was lowered from 75 to 72 years, and the dollar level at which the earnings deduction began to take effect for a person between the ages of 65 and 72 was raised from $900 to $1,200. For persons under 65 (who must be retired under a public retirement system to qualify for the credit) the dollar level for the earnings limitation remained $900. The income eligible for credit was reduced by $1 for each $1 of earnings in excess of the limits imposed.

H.R. 6371 is designed to amend the provisions of the retirement income credit to conform to the changes made in recent years by amendments to the Social Security Act. For taxable years ending after its enactment, the bill would increase the maximum amount of income eligible for credit from $1,200 to $1,524. The new figure is the annual equivalent of the maximum primary social security benefit of $127 a month established in the 1958 amendments to the Social Security Act.

The bill would also liberalize the present earnings limitation. As a result, people between the ages of 65 and 72 would no longer lose $1 of income eligible for the credit for each dollar of earnings in excess of $1,200; rather they would lose $1 for every $2 of earnings in excess of $1,200 but not in excess of $1,700. Earnings in excess of $1,700 would continue to reduce the income eligible for the credit on a dollar-for-dollar basis.

The new liberalized earnings limitation described above would also apply to individuals between the ages of 62 and 72 who are retired on a pension received from a public retirement system. Individuals under 62 who are retired on such pensions would not be eligible for the liberalized earnings limitation; instead they would continue to be subject to the limitation under the present law which reduces the amount of their retirement income eligible for the credit on a dollar-for-dollar basis for any earned income in excess of $900.

It is estimated that the enactment of this bill would cause a revenue loss of $40 million.

In the words of the House report accompanying H.R. 6371, Congress designed the retirement income credit, "to give those who have retirement income, but do not receive tax-exempt benefit payments, a tax exemption of approximately the same size as that received by social security beneficiaries." However, as the level of social security benefits increases, it is necessary to examine the adequacy of the method selected for achieving this objective.

The maximum primary social security benefit of $1,524 is not a proper benchmark for the purpose of the retirement income credit, since it does not represent the amount received by the average social security beneficiary. Virtually no one under the social security system today receives the maximum primary benefit. In fact, at the end of 1960, the average social security benefit received by retired-worker families was only $1,014. Because the social security primary benefit amount is based upon the maximum earnings base of $4,800 that was established in 1958, very few persons will even become eligible for the maximum benefit before 1963. Even when the $1,524 benefit becomes possible, the average level of benefits will, of course, be far below that amount.

Thus, under the provisions of H.R. 6371, individuals with sufficient retirement income would be able to exempt from tax a sum greater than the nontaxable benefits received by practically all social security beneficiaries. Moreover, married couples would be able to claim a double credit, provided both qualified, which would raise their income eligible for credit to $3,048. Data are not available on social security benefits received by married couples where each spouse is receiving benefits based on his own earnings. However, in 1960 the sum of the average benefits received by eligible male and female workers amounted to $1,676—considerably less than the $3,048 possible credit base under the bill.

The full benefits provided under H.R. 6371 would be available to only a limited number of taxpayers with substantial retirement incomes. According

to the 1960 Census of Population, there were 16.6 million people aged 65 or over in that year. Only 46 percent of these, an estimated 7.7 million filed tax returns in 1960; of those filing returns an estimated 3.8 million or 49 percent filed nontaxable returns. Only 2.7 percent of the people 65 or over, an estimated 451,539 persons, claimed the retirement income credit on taxable 1960 returns. For the 273,000 older persons currently claiming the credit on nontaxable returns a larger base for credit would, of course, be of no value. It is estimated that increasing the credit under provisions of the bill would benefit only between 100,000 and 150,000 aged persons.

While the bill would not aid those with low retirement incomes, it would help those with large retirement incomes. A married couple able to use a double credit could reduce their tax bill by as much as an additional $129.60 under the provisions of this bill. This would raise to $7,000 the amount such a couple could receive free of tax if they are both over 65 and their earnings entirely from dividends. Few persons 65 or over have incomes of this magnitude; the median 1960 income for families with a head 65 years of age or over was only $2,897.

The bill would also benefit persons who must now reduce their base for credit as a consequence of their substantial earnings. It would provide persons earning more than $1,200 but less than $2,974 with a greater tax credit for their retirement income than they now receive. This effect appears to be inconsistent with the retirement objective of the credit.

The bill would also benefit persons now receiving social security or railroad retirement benefits in addition to their other retirement income. An increase in the limit from which the amount of such tax-exempt receipts must be subtracted would leave more income eligible for credit than these people may now claim. This effect appears to be inconsistent with the basic intent of the credit, which is to eliminate tax discrimination in favor of persons with social security and other nontaxable pension and annuity income. Furthermore, only a few of the more than 11 million social security and railroad retirement beneficiaries would be able to take advantage of the increased base for credit.

The provisions of H.R. 6371 would give a tax advantage to persons with otherwise taxable retirement income that would be substantially larger than the tax benefits received by the average retired worker receiving social security benefits. This advantage would not be available to the vast majority of retired workers, but only to the relatively small number with substantial retirement income, or with retirement income in addition either to earned income or nontaxable pension or annuity income.

The income and tax status of retired persons and the elderly has been affected in recent years by significant changes in social security, other public retirement programs, and expanding private pension and retirement plans. In the case of social security alone, there have been four major changes made since 1954—in 1956, 1958, 1960, and 1961. The rapidity with which these changes have occurred suggests the desirability of a complete reexamination of the practice of tying provisions of the Internal Revenue Code to the Social Security Act.

As you know, the President has directed the Treasury to undertake the research and preparation of a comprehensive tax reform program. A major aspect of this program will be a broadened and more equitable tax base and reconsideration of the rate structure. We believe that the problem that H.R. 6371 attempts to meet should be considered in connection with such a general tax program. This would permit consideration of the problem in the light of a general examination of issues in both the area of pension and retirement income and the tax treatment of the elderly. Accordingly, the Department recommends that legislation dealing with the retirement income credit be deferred until it can be considered in the perspective of the entire tax reform program. The Treasury Department, therefore, does not favor the enactment of H.R. 6371.

The Bureau of the Budget has advised the Treasury Department that there is no objection from the standpoint of the administration's program to the presentation of this report.

Sincerely yours,

STANLEY S. SURREY,
Assistant Secretary.

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